WHY IS SBA LOSING GROUND ON FINANCIAL MANAGEMENT?

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY AND FINANCIAL MANAGEMENT

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 29, 2003

Serial No. 108–49

Printed for the use of the Committee on Government Reform

Available via the World Wide Web: http://www.gpo.gov/congress/house
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

89–351 PDF WASHINGTON : 2003

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WHY IS SBA LOSING GROUND ON FINANCIAL MANAGEMENT?

TUESDAY, APRIL 29, 2003

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY AND FINANCIAL MANAGEMENT,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2154, Rayburn House Office Building, Hon. Todd Russell Platts (chairman of the subcommittee) presiding.

Present: Representatives Platts, Blackburn and Towns.

Staff present: Mike Hettinger, staff director; Dan Daly, counsel; Larry Brady and Kara Galles, professional staff members; Amy Laudeman, clerk; Mark Stephenson, minority professional staff member; and Cecelia Morton, minority office manager.

Mr. PLATTS. A quorum being present, this hearing of the Subcommittee on Government Efficiency and Financial Management will come to order. Welcome, everyone, here today, and I appreciate everyone's participation.

As 1 of the 24 Chief Financial Officer Act agencies, the Small Business Administration [SBA], has been required to produce agencywide audited annual financial statements since fiscal year 1996, and has been required to produce audited financial statements with respect to its loan programs since fiscal year 1991. Since 1996, SBA has consistently received a clean opinion from their auditors on their agencywide financial statements. However, recently SBA's auditors issued a disclaimer on the fiscal year 2002 financial statements and chose to withdraw its clean opinions on SBA's financial statements for fiscal years 2001 and 2000. This turnaround occurred in part as a result of the findings described in the General Accounting Office report entitled, "Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain."

As part of the subcommittee's continuing oversight into the financial health of the CFO Act agencies, we have asked the General Accounting Office, representatives of the SBA, and SBA's independent auditors to come before us today to discuss the current status of the financial accounting situation at SBA. Our hearing today will address the findings of the GAO report as well as look forward at the remediation efforts underway within SBA to rectify this situation.

Last year, at the request of Senator Christopher Bond, GAO conducted a broad review of SBA's loan asset sales program. GAO ana-

lyzed the way SBA accounted for five loan asset sales, disposing of a total of $4.4 billion in disaster assistance home and business loans from August 1999 through January 2002. GAO determined that SBA incorrectly calculated accounting losses on the loan sales and lacked reliable financial data to determine the overall financial impact of the sales. SBA's accounting for the loan sales was flawed to such a degree that SBA was showing a profit on its disaster relief loans, a very unlikely scenario.

In part, as a result of the accounting inaccuracies uncovered by GAO, SBA auditors, Cotton & Co., issued a disclaimer on SBA's financial statements for fiscal year 2002 and withdrew the clean audit opinions on SBA's financial statements for fiscal years 2001 and 2000. Furthermore, the Office of Management and Budget reported as part of the President's executive branch Management Scorecard for 2002 that SBA actually deteriorated on its score for improving financial performance since last year. OMB's explanation of the score cited the challenges that SBA faces in accounting for its loan sales, meeting accounting performance standards and measuring risk in its loan portfolio more accurately.

SBA's Chief Financial Officer and its inspector general both generally agree with the overall findings and recommendations in the GAO report, and the Chief Financial Officer has contracted with a consulting firm to assist them in determining where they made their mistakes in accounting for the loan sales. The Inspector General's Office is also working with Cotton & Co. to determine the magnitude of the errors in SBA's financial statements for fiscal year 2001 and 2000.

The situation at SBA raises serious questions about the quality of the financial management of SBA's loan asset sales. It also demonstrates a point that is consistently raised by GAO and OMB: Sound financial management requires more than clean audit opinions.

I was gratified when I read an advance copy of the Deputy Inspector General McClintock's testimony that he candidly discusses how flawed SBA's financial management systems are, and if the systems were not so flawed, perhaps SBA would have clean audit opinions today. The SBA has the opportunity now to reevaluate its management of the loan asset sales and to move forward with solutions that will result in sustainable long-term improvements to their financial management efforts.

Our witnesses here today will help to shed light on the financial management situation at SBA, and, again, we are very pleased and grateful for your participation in today's hearing. We are pleased to have Linda Calbom, who is a Director with the Financial Management and Assurance Team at the General Accounting Office; Thomas Dumaresq, who is Chief Financial Officer at SBA; Peter McClintock, who is the Deputy Inspector General at SBA; Mr. Charles Hayward, who has worked on the SBA audit as a partner with Cotton & Co.; and Bill Menth, who is a consultant that has been working on this situation with both Cotton & Co. and SBA.

I know that my fellow committee members join me in looking forward to your testimonies, and I'm pleased now to yield to the gentleman from New York, the ranking member, Mr. Towns, for the purpose of making an opening statement.

[The prepared statement of Hon. Todd Russell Platts follows:]

ONE HUNDRED EIGHTH CONGRESS

Congress of the United States

House of Representatives

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Opening Statement
Congressman Todd R. Platts
April 29, 2003

As one of the 24 Chief Financial Officer Act (CFO Act) agencies, the Small Business Administration (SBA) has been required to produce agency-wide audited annual financial statements since fiscal year 1996, and has been required to produce audited financial statements with respect to its loan programs since fiscal year 1991. Since 1996, SBA has consistently received a clean opinion from their auditors on their agency-wide financial statements. However, recently SBA's auditors issued a disclaimer on SBA's fiscal year 2002 financial statements and chose to withdraw their clean opinions on SBA's financial statements for fiscal years 2001 and 2000. This turnaround occurred in part as the result of the findings described in the General Accounting Office (GAO) report, entitled *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain.* [1]

As part of this subcommittee's continuing oversight into the financial health of the CFO Act agencies, we have asked the General Accounting Office (GAO), representatives of the SBA, and SBA's independent auditors to come before us today to discuss the current status of the financial accounting situation at SBA. Our hearing today will address the findings of the GAO report, as well as look forward at the remediation efforts underway within SBA to rectify this situation.

Last year, at the request of Senator Christopher Bond, GAO conducted a broad review of SBA's loan asset sales program. GAO analyzed the way SBA accounted for five loan asset sales, disposing of a total of $4.4 billion in disaster assistance home and business loans and regular business loans, from August 1999 through January 2002. GAO determined that SBA incorrectly calculated the accounting losses on the loan sales and lacked reliable financial data to determine the overall financial impact of the sales. SBA's accounting for the loan sales was flawed to such a degree that SBA was actually showing a profit on their disaster relief loans - a very unlikely scenario. In part, as a

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[1] GAO-03-87, January 2003.

result of the accounting inaccuracies uncovered by GAO, SBA's auditors, Cotton and Company, issued a disclaimer on SBA's financial statements for fiscal year 2002 and withdrew their clean audit opinions on SBA's financial statements for fiscal years 2001 and 2000. Furthermore, the Office of Management and Budget (OMB) reported as part of the President's Executive Branch Management Scorecard for 2002 that SBA actually deteriorated on its score for improving financial performance since last year. OMB's explanation of the score cited the challenges that SBA faces in accounting for its loan sales, meeting accounting performance standards, and measuring risk in its loan portfolio more accurately.

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Our witnesses today will help to shed light on the financial management situation at SBA. We are pleased to have Linda Calbom, who is a Director with the Financial Management and Assurance team at the General Accounting Office; Thomas Dumaresq, who is the Chief Financial Officer at SBA; Peter McClintock, who is the Deputy Inspector General at SBA; Charles Hayward, who worked on the SBA audit as a partner with Cotton and Company; and Bill Menth, who is a consultant that has been working on this situation with both Cotton and Company and SBA. I look forward to your testimonies.

Mr. TOWNS. Thank you very much, Mr. Chairman. Thank you for holding this hearing today on SBA's financial management problems.

The information presented to us on SBA is certainly troubling; however, I am pleased that the agency has acknowledged its errors and is ready to confront those mistakes. It seems that they are sincere about, making the necessary changes to prevent a similar situation from happening again. Having key members from SBA along with the consultants in the GAO to discuss the agency's financial statement is a good starting point.

Although today's hearing is focusing on SBA, it could very well be taking place on several of the over 24 CFO Act agencies. As many of you know, the SBA received clean audit opinions in 2000 and 2001 before errors were discovered that invalidated those findings. So it is entirely possible that an agency which got a clean audit this year does not really have all of its financial cards in order. As we learn more about what went wrong at SBA and what we can do to prevent it from happening again, it is critical that we apply those lessons learned to other agencies.

With that said, I do believe it is important that this committee zero in on SBA and its own specific problems. Small business is the backbone of our economy, producing 75 percent of all new jobs and employing half the private-sector work force. Minority and women-owned firms are the fastest-growing segment of this business community. Over a 5-year period the number of minority-owned firms have increased at a rate four times greater than all other firms in the United States and have grown their receipts by 60 percent. This success is in part due to the availability of loan assistance from the SBA.

With these statistics in mind, I believe it is critical that the agency solve its financial management problems. Our economy and especially our minority entrepreneurs need a healthy SBA in order to flourish.

Thank you, Mr. Chairman. I yield back the balance of my time, and I'm anxious to hear from the witnesses.

Mr. PLATTS. Thank you, Mr. Towns.

[The prepared statement of Hon. Edolphus Towns follows:]

Congressman Ed Towns
Subcommittee on Government Efficiency and Financial Management
Why is SBA Losing Ground on Financial Management
April 29, 2002

Mr. Chairman, thank you for holding this hearing today on SBA's financial management problems. The information presented to us on SBA is certainly troubling. However, I am pleased that the agency has acknowledged its errors and is ready to confront those mistakes. It seems that they are sincere about making the necessary changes to prevent a similar situation from happening again. Having key members from SBA here today along with their consultants and the GAO to discuss the agency's financial statements is a good starting point.

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receipts by 60%. This success is in part due to the availability of loan assistance from the SBA.

With these statistics in mind, I believe it is critical that the agency solve its financial management problems. Our economy and especially, our minority entrepreneurs need a healthy SBA in order to flourish.

Thank you Mr. Chairman and I yield back the balance of my time.

Mr. PLATTS. I would like now to ask each witness to stand and any other persons who will be advising you during your testimony to stand, raise your right hands, and we will issue the oath together and then proceed with testimony.

[Witnesses sworn.]

Mr. PLATTS. Thank you, and the clerk will note that all witnesses affirm the oath.

I'd like to now proceed directly to the testimonies. Ms. Calbom, we'll begin with you, followed by Mr. Dumaresq, then Mr. McClintock, Mr. Hayward and Mr. Menth. The subcommittee appreciates the very substantive written testimonies that you provided to us in advance, and each has been submitted as part of the record.

Because of the detail and the importance of the items we are going to be discussing today, I would like to extend to each of you 10 minutes as opposed to the customary 5 for your opening statements, and then we'll proceed to questions.

Ms. Calbom, the floor is yours.

STATEMENT OF LINDA CALBOM, DIRECTOR OF FINANCIAL MANAGEMENT AND ASSURANCE, U.S. GENERAL ACCOUNTING OFFICE

Ms. CALBOM. OK. Thank you, Mr. Chairman, Mr. Towns, Mrs. Blackburn. I'm pleased to be here today to discuss the results of our review of SBA's accounting for its loan sales and the cost of its credit programs. My testimony today is going to summarize the findings in the report we issued in January of this year, which you've referred to, Mr. Chairman. I'll also just briefly touch on other financial management issues that were identified by SBA's auditors during their audit of the fiscal year 2002 financial statements.

Our review disclosed that SBA has fundamental problems with accounting for its credit programs, particularly the disaster loan program. These problems became more and more evident as SBA carried out its loan sales. Loan sales didn't actually cause the problems, but did bring them to light sooner than may have otherwise occurred.

SBA began its loan sales activity around the end of fiscal year 1999 and to date has sold well over half of its direct loan portfolio, the bulk of which represents disaster loans. As these sales have occurred, a steep decline in the subsidy allowance account for disaster loans, which is meant to cover the cost of the program, has also occurred. This decline is graphically depicted on the chart that we've got here and up on the overheads. It's also on the highlights page of my written testimony. As you can see, the subsidy allowance account eventually went negative in 2001, and then continued to go even further negative in 2002. A negative balance in a subsidy allowance account would only ever make sense if a profit was expected from the program, which was not the case for the highly subsidized disaster loan program. In this case the negative balance likely means that more reserves were being taken out of the account than had ever been put in to cover the cost of the program.

While SBA and its consultants are still analyzing the cause of this anomaly, it appears that one of the key problems is that the average loan term used to calculate the subsidy cost was too short.

SBA had estimated the average loan term for disaster loans to be 16 to 17 years. Based on our review of the disaster loans sold in the first five sales, the average loan term was more like 25 years. This is a very significant difference when you're dealing with a program like disaster loans where you have interest rates that are below market and, therefore, the longer the loan term, the more costly the program.

We also found other problems during our review of SBA loan sales, the first of these being that the estimated accounting losses on the sales were incorrectly calculated. We reviewed the methodology SBA used to calculate these losses and found significant errors in how the subsidy allowance was allocated to the loans that were sold, thereby misstating the losses on the sales.

Theoretically this type of error would have been corrected when SBA reestimated the cost of its loan programs, which they're generally required to do on an annual basis. These reestimates are done to adjust the cost of the programs for any changes in the key assumptions that went into the original cost estimates. However, we also found as part of our review that SBA's reestimates of subsidy costs were unreliable. At the time of our review, even after selling nearly half of its loan portfolio, SBA had not analyzed the effect of the loans sales on the estimated costs of the remaining portfolio. Therefore they did not know if their original assumptions about the characteristics of the portfolio were still valid.

Despite the significant unexplained decline in the subsidy allowance and the other issues I've just outlined, SBA received unqualified or "clean opinions" on its fiscal year 2000 and 2001 financial statements. We discussed these issues with SBA's auditors, and they have since reevaluated and withdrawn their unqualified opinions for 2002 and 2001.

SBA's inability to account for its loan sales or adequately reestimate the cost of loans not sold, combined with other financial management issues, led the auditors to issuing a disclaimer of opinion on SBA's fiscal year 2002 financial statements. Other issues identified during the fiscal year 2002 audit that impacted the opinion included problems in accounting for pre-1992 loan guarantees and uncertainties surrounding the balance in the Master Reserve Fund, which is maintained by SBA's fiscal agent as part of its administration of the 7(a) secondary market program. The auditor reported material internal control weaknesses related to these and other issues, including SBA's financial reporting process. According to the auditors, SBA continued to experience widespread difficulties in producing accurate, timely and adequately supported financial statements.

In closing, Mr. Chairman, SBA's financial management deficiencies are quite severe and point to an inability to provide full accountability for taxpayer funds provided to the agency for carrying out its programs. We made a number of recommendations in our January report covering these matters as they related to loan sales and subsidy cost estimates. The SBA agreed with our recommendations and contracted with an independent consulting firm to assist them in completing a more detailed analysis of their loan sale accounting and cost estimation procedures. Based on our recent discussions with SBA officials, we understand that they are

making good progress in identifying potential causes of the problems and actions to address them, and we look forward to assessing the results of these activities.

Thanks, Mr. Chairman.

Mr. PLATTS. Thank you, Ms. Calbom.

[NOTE.—The GAO report entitled, "Small Business Administration, Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain," may be found in subcommittee files.]

[The prepared statement of Ms. Calbom follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Efficiency and Financial Management

For Release on Delivery
Expected at 2 p.m. EDT
April 29, 2003

SMALL BUSINESS ADMINISTRATION

Loan Accounting and Other Financial Management Issues Impair Accountability

Statement of Linda M. Calbom, Director
Financial Management and Assurance

G A O
Accountability * Integrity * Reliability

April 29, 2003

SMALL BUSINESS ADMINISTRATION

Loan Accounting and Other Financial Management Issues Impair Accountability

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-03-676T, a testimony before the Subcommittee on Government Efficiency and Financial Management

Why GAO Did This Study

Recently, the Small Business Administration's (SBA) auditors withdrew their unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion. The auditors also issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. This turn of events was primarily due to flaws in the way SBA accounted for its loan sales and for the remaining portfolio. There were also several other issues affecting SBA's fiscal year 2002 audit, including key internal control weaknesses and systems that did not substantially comply with the Federal Financial Management Improvement Act. The information GAO presents in this testimony, which is discussed in greater detail in our January 2003 report, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain* (GAO-03-87), is intended to assist Congress in assessing the current status of financial accountability at SBA.

What GAO Recommends

GAO is not making new recommendations in this testimony, but in a past report has made specific recommendations aimed at addressing the deficiencies in the accounting for loan asset sales and the remaining portfolio.

www.gao.gov/cgi-bin/getrpt?GAO-03-676T.

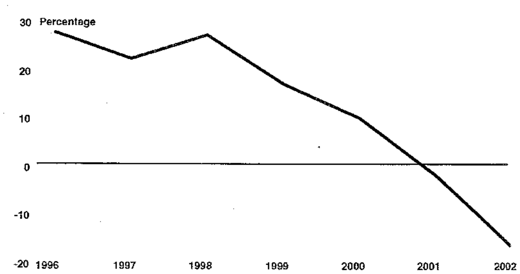
To view the full testimony, click on the link above.
For more information, contact Linda Calbom at (202) 512-9508 or calboml@gao.gov.

What GAO Found

From August 1999 through April 2003, SBA held eight loan asset sales, disposing of a total of $6.5 billion in disaster assistance and business loans. Our review of the budgeting and accounting for the first five loan sales found errors that could significantly affect the reported results in SBA's budget and financial statements. We found that SBA (1) incorrectly calculated losses on loan sales reported in the footnotes to its financial statements, (2) did not appropriately consider the effect of loan sales on its estimates of the cost of the remaining portfolio, which could significantly affect its budget and financial statement reporting, and (3) had significant unexplained declines in its subsidy allowance for the disaster loan program. As shown in the figure, the subsidy allowance eventually declined to a negative balance, which indicated that SBA expected profits on its subsidized disaster loans.

Despite these errors and uncertainties, SBA's auditor gave unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements. We discussed these issues with SBA's auditors, who have since reassessed the unusual balance in the subsidy allowance account and withdrawn their unqualified audit opinions on the fiscal year 2000 and 2001 financial statements. The agency's inability to properly account for its loans sold and not sold, combined with several other financial management issues, led the auditors to issue a disclaimer of opinion on SBA's fiscal year 2002 financial statements. Until SBA corrects its financial management deficiencies, the agency's financial accounting and budgetary reporting will be unreliable. Based on recent discussions with SBA officials, we understand that they are making progress in identifying the sources of the loan accounting problems and in determining corrective actions.

SBA Disaster Loans Subsidy Allowance



Subsidy allowance as a percentage of disaster loans outstanding

Source: GAO.

Note: Analysis based on SBA data.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the status of financial management at the Small Business Administration (SBA). Recently SBA's auditor withdrew its unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion. The auditor also issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. This turn of events was primarily due to flaws we identified in the way SBA accounted for its loan sales and for the remaining portfolio. There were also several other issues affecting SBA's fiscal year 2002 financial statement audit, including key internal control weaknesses and systems that did not substantially comply with the Federal Financial Management Improvement Act (FFMIA). I will discuss all of these issues today which, when combined, point to an overall lack of financial accountability at SBA.

SBA's Accounting for Loan Sales and the Remaining Portfolio was Flawed

This January, we reported[1] that SBA had sold almost 110,000 loans with an unpaid principal balance of about $4.4 billion in five loan sales from August 1999 through January 2002.[2] Our review of the budgeting and accounting for these loan sales found errors that could significantly affect the reported results in SBA's budget and financial statements.

[1] U.S. General Accounting Office, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: Jan. 3, 2003).

[2] SBA has held three additional loan sales that were not included in our review. In August 2002, SBA held its sixth sale, which included about 30,000 loans with an outstanding balance of $657 million. The seventh sale took place in December 2002 and consisted of about 29,000 loans with an outstanding balance of $682 million. The eighth sale consisted of about 25,000 loans with an outstanding balance of about $721 million and took place in April 2003. In all eight sales SBA has sold about 192,000 loans with an outstanding balance of $6.5 billion.

We found that SBA (1) incorrectly calculated losses on loan sales reported in the footnotes to its financial statements, (2) did not appropriately consider the effect of loan sales on its estimates of the cost of the remaining portfolio, which could significantly affect its budget and financial statement reporting, and (3) had significant unexplained declines in its subsidy allowance[3] for the disaster loan program. Until SBA makes the necessary corrections to its procedures to estimate the cost of its credit programs, including the effect of its loan sales, the reliability of the current and future subsidy rates will remain unknown. We understand that SBA is taking steps to address the issues we identified, including working with a consulting firm to perform a detailed analysis of its loan sale accounting and cost estimation procedures.

SBA Improperly Calculated Losses on Loan Sales

Accounting records related to SBA's first five loan sales indicated that losses exceeded $1.5 billion. However, this amount is overstated because of errors in the way SBA calculated the losses. Because of the lack of reliable financial data, we were unable to determine the financial effect of loan sales on SBA's budget and financial statements. These errors raise serious concerns about the information related to the results of loan sales included in the footnotes to the annual financial statements that SBA provided to the Office of Management and Budget (OMB) and the Congress for decision-making purposes.

[3] For a subsidized loan program, the subsidy allowance account generally represents the subsidized portion – the amount of expected losses related to estimated defaults and financing costs from making below-market rate loans – assumed by the federal government. The subsidy allowance account is subtracted from the loans receivable balance on the balance sheet to arrive at the net loan amount expected to be repaid.

For accounting purposes, the gain or loss on a loan sale represents the difference between the net book value (the outstanding loans receivable balance minus the subsidy allowance) of the loans sold and the net sale proceeds.[4] The footnotes to SBA's fiscal year 1999 and 2000 financial statements reported accounting losses of $75 million and $600 million, respectively, on its loan sales. SBA did not separately disclose the losses calculated on the two loan sales that took place during fiscal year 2001.[5] According to SBA's accounting records, the first five sales resulted in total losses of more than $1.5 billion.

Prior to a loan sale, an estimate of the loans' current value to the government or "hold value" is calculated to determine what the loans are worth to the government in the event that the loans are held to maturity or some other resolution, such as prepayment or default.[6] This hold value is compared to an estimate of the expected net sale proceeds to determine if it is advantageous for the loans to be sold.[7] After a sale, the hold value is compared to the actual net sale proceeds to determine whether or not and by how much the government benefited from the sale. SBA determined that the first five loan sales resulted in a $606 million benefit to the government.[8] This benefit calculation differs from the accounting gain or loss because the benefit calculation is not designed to take into consideration changes in interest rates from the time the loans were disbursed to the date of the sale, while the accounting gain or loss, if properly computed, does take these changes into account.

[4] OMB Circular A-11 defines net sale proceeds in the context of loan sales as the amounts paid by purchasers less all seller transaction costs (such as underwriting, rating agency, legal, financial advisory, and due diligence fees) that are paid out of the gross sales proceeds rather than paid as direct obligations by the agency.

[5] SBA also did not disclose any gain or loss on the two loan sales, number 5 and 6, which took place during fiscal year 2002 in its financial statements for that year.

[6] The hold value is calculated on a present value basis, meaning the worth of a future stream of returns or costs in terms of money paid immediately. In calculating the hold value, interest rates from the most recent President's budget at the time the estimate is prepared provide the basis for converting future amounts into their "money now," or present value, equivalents.

[7] OMB reviews these calculations as part of its approval process for SBA to conduct a loan sale.

[8] We did not audit the data used to calculate the hold values for each sale, and therefore did not conclude on the reasonableness of the hold values for any of the sales.

We reviewed the methodology SBA used to calculate the results of its loan sales for accounting purposes and found significant errors. When calculating whether loans are sold at a gain or a loss, agencies must estimate the portion of the subsidy allowance to allocate to each loan sold in order to calculate the net book value for those loans. Since SBA's calculation of the net book value of the loans sold exceeded the net proceeds from the sales, losses were calculated. Our review of these calculations found that SBA's estimates did not consider all the appropriate cash flows when allocating the subsidy allowance to the sold loans. For example, when calculating the gains or losses for the disaster loan program, SBA failed to allocate a portion of the subsidy allowance for financing costs associated with lending to borrowers at below market interest rates. Doing so would have reduced the amount of loss that SBA reported on the loan sales.

In addition, SBA incorrectly allocated the subsidy allowance for the previously defaulted 7(a) and 504 guaranteed loans, which could materially distort the gain or loss. SBA used its estimated net default cost, which considers first the probability of default and then the estimated recovery rate after default. For example, if a $10,000 guaranteed loan has an estimated default rate of 10 percent and an estimated recovery rate of 50 percent, the subsidy allowance allocated by SBA would be $500 ([$10,000 x .10] x .50). Therefore, the net book value calculated for the loan would be $9,500. However, since guaranteed loans sold have already defaulted, it is not appropriate to apply the estimated default rate of 10 percent. SBA should have applied only the estimated recovery rate of 50 percent for these loans, and the subsidy allowance allocated would be $5,000 ($10,000 x .50) and the net book value calculated for the loan would be $5,000. Figure 1 illustrates the difference in the calculated gain or loss resulting from this error if the previously defaulted loan were sold for $6,500. The left column, based on SBA's incorrect methodology, shows that the loan was sold for a $3,000 loss, while the right column appropriately allocates the allowance based on expected recoveries and results in a $1,500 gain, a difference of $4,500 for this example of a $10,000 guaranteed loan sold.

Figure 1: Gain / Loss Calculation on Previously Defaulted Guaranteed Loans Sold

Dollars

SBA's method		Correct method	
Previously defaulted loan guarantee	$10,000	Previously defaulted loan guarantee	$10,000
Less allowance based on net defaults (defaults less recoveries)	500	Less allowance based on portion not expected to be recovered	5,000
Net book value	9,500	Net book value	5,000
Net sale proceeds	6,500	Net sale proceeds	6,500
Loss	**($3,000)**	**Gain**	**$1,500**

Source: GAO analysis.

SBA's errors in calculating the losses on disaster loans and previously defaulted guaranteed loans sold both resulted in overestimates of the net book value of the loans sold and the losses that SBA reported in the footnotes to its fiscal year 1999 and 2000 financial statements. Because of the way the results of loan sales are incorporated in the budget and the financial statements, the reestimates, if done properly, should have corrected the impact of these errors. However, as I discuss next, the reestimates were not reliable.

Subsidy Cost Reestimates are Unreliable

SBA did not conduct key analyses of the loans sold and those remaining in its portfolio so it could determine how the sales affected its reestimates of program costs for its remaining loans. OMB's budget guidance directs agencies to make reestimates for all changes in cash flow assumptions in order to adjust the subsidy estimate for differences between the original estimated cash flows and the actual cash flows. SBA officials acknowledged that analyses of the impact of loan sales on its historical averages should be done. However, they told us they lacked the appropriate historical data and resources to perform these analyses. Because SBA did not assess the effect loan sales would have on its historical averages of loan performance, such as when loans default or prepay, the agency did not know whether these averages, which can significantly affect the estimated cost of a loan program, reasonably predict future loan performance. As a result, information in both the budget and financial statements related to the reestimated cost of SBA's loan programs cannot be relied upon.

SBA is generally required to update or "reestimate" loan program costs annually. OMB Circular A-11 directs agencies to do reestimates for all changes in cash flow assumptions. Thus, reestimates should include all

aspects of the original cost estimate, including prepayments, defaults, delinquencies, and recoveries. These reestimates are done to adjust the subsidy cost estimate for differences between the original cash flow projections and the amount and timing of cash flows that are expected based on actual experience, new forecasts about future economic conditions, and other events that affect the cash flows.

Even after selling about $4.4 billion of loans, nearly half of its loan portfolio, SBA had not analyzed the effect of loan sales on the estimated cost of the remaining loans in its portfolio. SBA officials told us loans are selected for sale based on certain criteria, such as where the loan is located or serviced, the type of collateral, or whether the loan is performing. Since the loan selection process is not random—that is, all loans do not have an equal chance of being selected—it is likely that the loans sold had different characteristics than the portfolio's historical averages prior to sales. Consequently, the characteristics of the remaining loans may also differ substantially from the portfolio historical averages prior to the sales. For example, during our analysis of the loans that were sold, we determined that 84 percent of the $3.8 billion of disaster loans sold were performing–meaning that payments were not more than 30 days delinquent. Selling mostly performing loans could leave a disproportionate level of nonperforming loans in SBA's portfolio. Because SBA had not analyzed the effect of loan sales on the characteristics of its remaining portfolio, it does not know if the percentages of remaining performing and nonperforming loans are different from the historical averages prior to the sales. A change in these percentages could indicate that expected defaults in the remaining portfolio could be higher or lower than current assumptions, based on historical data, suggest.

Another important loan characteristic is the stated loan term. This term is the contractual amount of time borrowers have to repay their loans. SBA's estimated costs of the disaster loan program are based on historical average loan term assumptions of 16 years for business disaster loans and 17 years for home disaster loans. Based on our review of the disaster loans sold in the first five sales, the average loan term was about 25 years. However, SBA continued to use average loan term assumptions of 16 and 17 years in its reestimates without doing the appropriate analysis to determine whether these assumptions were still valid. Based on our recent discussion with SBA officials, their detailed analysis of the cost estimation procedures for the disaster loan program found that, among other things, the average loan term assumption should have been greater. Relatively minor changes in some cash flow assumptions, such as higher or lower

default and recovery rates and changes in loan terms, can significantly affect the estimated cost of the loan program and therefore the program's budget.

The Subsidy Allowance Account Was Misstated

During our review of the accounting for loan sales, we noted that the subsidy allowance account for the disaster loan program had an unusually low balance. For a subsidized loan program, the subsidy allowance account is generally the amount of expected losses on a group of loans related to estimated defaults and financing costs from making below-market rate loans. In effect, the subsidy allowance is the cost associated with the loans that SBA does not expect to recover from borrowers. For financial reporting purposes, the subsidy allowance reduces the outstanding loans receivable balance to the amount that SBA expects to collect from borrowers, known as the net loans receivable balance (or net book value), which is shown on the balance sheet.

Table 1 summarizes the disaster loan program's reported outstanding loans receivable balance, the subsidy allowance balance, the net book value, and the subsidy allowance as a percentage of the loans receivable balance for fiscal years 1998 through 2002. The reported subsidy allowance compared to the loans receivable balance decreased significantly in fiscal years 2000 and 2001, to the point of showing that the remaining portfolio of the disaster program was expected to generate a profit. This declining trend continued into fiscal year 2002. SBA could not provide support for the balance or explain the reason for this anomaly.

Table 1: Reported Loans Receivable Balances of SBA's Disaster Loan Program

Dollars in millions

Disaster loan program	Fiscal year 1998	Fiscal year 1999	Fiscal year 2000	Fiscal year 2001	Fiscal year 2002
Loans receivable Outstanding	$5,614	$5,659	$5,305	$3,293	$3,110
Less / (plus): subsidy allowance balance	$1,502	$929	$505	($77)	($522)
Net book value	$4,112	$4,730	$4,800	$3,370	$3,632
Subsidy allowance as a percentage of loans receivable balance	26.8%	16.4%	9.5%	(2.3%)	(16.8%)

Source: SBA.

Table 1 shows a rapid decrease in the reported subsidy allowance between fiscal year 2000 and 2001. Most of this decrease actually occurred in fiscal year 2000, but was masked by an adjustment made during the fiscal year 2000 financial statement audit. Before SBA made the audit adjustment, the subsidy allowance for the disaster program was about $91 million for fiscal year 2000. This balance was $838 million, or about 90 percent, less than the $929 million balance for fiscal year 1999, while loans receivable outstanding decreased by only $354 million, or about 6 percent.

In order to restore the subsidy allowance to a more reasonable balance at the end of fiscal year 2000, in agreement with its auditor, SBA increased the subsidy allowance balance by recording an audit adjustment that was essentially meant to reflect the expected impact of loan sales on the reestimates prepared in fiscal year 2000, which did not factor in the effects of loan sales.[9] This increased the reported cost of the disaster loan program by $414 million in fiscal year 2000. Since the amount of the adjustment was based on SBA's erroneous calculations of loan sale losses, as previously discussed, the amount of the adjustment was incorrect. During fiscal year 2001, SBA reversed the audit adjustment and revised its reestimates to include cash flows related to loan sales. Our review of the fiscal year 2001 disaster loan program reestimates indicated that loan sales increased the reported cost of the program by about $292 million. However, this amount is also likely misstated because, as I previously mentioned, the reestimates did not consider the specific characteristics of the loans sold or the loans remaining in the portfolio.

[9] Theoretically, had the reestimates factored in the loan sales, the subsidy allowance account would have been appropriately adjusted, regardless of any errors made in recording the calculated accounting losses.

The unexplained decline in the subsidy allowance continued in the fiscal year 2001 financial statements where SBA reported a negative balance in the subsidy allowance for the disaster loan program. As shown in table 1, this allowance account no longer reduced the amount SBA expected borrowers to repay – it actually increased the expected repayments from borrowers and indicated that the loan program was profitable. However, because the program is subsidized, with estimated default and financing costs exceeding the amount of interest borrowers are expected to pay, it should not show an expected profit, and thus the balance for the subsidy allowance account appears to be significantly misstated.[10] As in the prior year, SBA could not explain the unusual balance. Based on our review of SBA's fiscal year 2002 financial statements, the unexplained trend continued and the negative balance of the subsidy allowance (expected profit) increased to $522 million.

While the objective of our work was not to determine the specific cause of the unusual balance, several possibilities exist. As previously mentioned, not considering the characteristics of the loans sold or of those remaining in SBA's portfolio could contribute to the unusual balance. Another possibility is that SBA may have underestimated the cost of its disaster loan program because the cash flow assumptions used to estimate the subsidy cost did not reflect the true characteristics or performance of its loan portfolio. For example, as I previously discussed, SBA used average loan term assumptions of 16 and 17 years to estimate the cost of the disaster loan program. However, based on recent discussions with SBA officials, they have found that the average loan term should have been greater. Underestimating the loan term would mean that SBA did not put enough into the subsidy allowance account to cover interest costs associated with these loans and the subsidy allowance would be depleted as these costs were written off against it until there was a negative balance. From a budgetary perspective, this could mean that SBA did not request an appropriation large enough to cover the cost of the loan program.

Despite the significant, unexplained decline in the subsidy allowance and the errors in calculating the losses on loan sales, SBA received unqualified or "clean" audit opinions on its fiscal year 2000 and 2001 financial statements. An unqualified audit opinion indicates that the balances in the

[10] Based on SBA's reestimates for its fiscal year 2001 financial statements, the subsidy cost of this program ranged from $17 to $33 for every $100 the federal government lends, depending on the interest rates in effect when the loans were made.

financial statements are free of significant errors, known as material misstatements. As previously mentioned, SBA's auditor attempted to adjust the anomalies in the subsidy allowance during the fiscal year 2000 financial statement audit. However, the adjustment was based on the previously described erroneous loss calculation. For the fiscal year 2001 audit, SBA's auditor performed a number of audit procedures related to the disaster loan program subsidy allowance account. For example, the auditor evaluated the methodology and formulas used to calculate reestimates, assessed data used to calculate key cash flow assumptions, and reviewed various internal controls over the subsidy estimation process. However, this work did not appear to focus on determining the cause of the unusual negative balance of the account, which, contrary to the fact that this is a subsidized loan program, would indicate that these loans were expected to generate a profit. The auditor's workpapers indicated that the auditor had agreed, in discussions with SBA management, that if the "methodology and data were materially correct, we [the auditor] would conclude that the resulting subsidy reserve [allowance] would be materially correct for financial statement reporting purposes." The workpapers also indicated that, "whatever the results of the reestimates are, as long as the methodology is sound and supportable, we [the auditor] would not consider the balance [of the subsidy allowance] anything other than 'natural.'"

Although SBA's auditor may have recognized some of the errors we identified, they did not determine the cause of the unusual balance and propose the necessary audit adjustments or modify their audit report as appropriate. In such situations, when auditors cannot determine whether a balance is fairly stated because sufficient reliable supporting documentation is not available, audit standards[11] call for auditors to either qualify their opinion with the noted exception or issue a disclaimer of opinion, meaning that the auditor was unable to obtain satisfaction that the financial statements are fairly stated and therefore does not express an opinion. We discussed these issues with SBA's auditor and they have since reevaluated and withdrawn their unqualified audit opinions on SBA's fiscal year 2000 and 2001 financial statements and issued disclaimers of opinion.

In response to our findings, SBA contracted with an independent consulting firm to complete a more detailed analysis of its loan sale accounting and cost estimation procedures to determine the cause of the

[11] Statements on Auditing Standards, AU §508 paragraphs 22 and 23.

unusual balance in the subsidy allowance account. We recently met with SBA officials to discuss the steps taken to date to address the issues we identified. We understand that SBA, working with the consultants, has identified a number of issues related to the methods and assumptions used to estimate the cost for the disaster loan program. While we have not had an opportunity to analyze their findings in detail, based on our previous work, several of the issues they identified, including the understated average loan term, appear to be plausible causes of the decline in the subsidy allowance for the disaster loan program.

Results of Fiscal Year 2002 Financial Statement Audit

SBA's inability to account for its loan sales or adequately reestimate the cost of loans not sold, combined with other financial management issues, led to the auditors issuing a disclaimer of opinion on SBA's fiscal year 2002 financial statements. I will now briefly discuss the disclaimer of opinion, the internal control weaknesses they reflect, and the consequences of these weaknesses regarding compliance with FFMIA.

Disclaimer of Opinion

The disclaimer of opinion for fiscal year 2002 was primarily due to three issues: (1) SBA's disaster loan modeling contained deficiencies and was no longer adequate for determining the costs of disaster loans sold or reestimating the cost of loans not sold, (2) SBA did not present future expected default costs on pre-1992 loan guarantees[12] or determine the correct valuation of related balances, and (3) SBA could not ensure that the balance in the Master Reserve Fund[13] residual asset or liability was reliable.

As I've previously discussed, SBA's inability to determine the cost of loans sold or adequately reestimate the cost of loans not sold could materially affect amounts reported in the budget and the financial statements. SBA and its consultants had not completed their analysis of SBA's loan sale accounting and cost estimation procedures prior to the completion of the fiscal year 2002 audit. Therefore, SBA was not able to provide sufficient

[12] Pre-1992 loan guarantees are loan guarantees committed prior to October 1, 1991. The accounting standard requires that the liabilities of pre-1992 loan guarantees be recognized when it is more likely than not that the loan guarantees will require a future cash outlaw to pay default claims.

[13] The 7(a) secondary market program, one of SBA's business loan programs, is administered by an agent of SBA. Payments for this program flow through the Master Reserve Fund.

evidence to its auditors to support certain amounts reported and disclosures made in its fiscal year 2001 and 2002 financial statements, thereby limiting the scope of the audit and leading to the disclaimer of opinion.

Additionally, SBA did not present future expected default costs on pre-1992 loan guarantees. SBA made several adjusting entries to both the fiscal year 2002 and fiscal year 2001 financial statements in an effort to correct this. However, SBA did not have a calculation methodology to determine its expected future default costs and related liability or to support the adjustments made. Therefore, SBA could not provide sufficient documentation that the liability balance of $116 million as of September 30, 2002, was fairly stated.

The final issue contributing to SBA's disclaimer related to the Master Reserve Fund. SBA's fiscal and transfer agent maintains the Master Reserve Fund to facilitate operation of the secondary market program[14] for 7(a) Business Loans, a loan guarantee program for small businesses that would otherwise be unable to obtain financing at reasonable rates. The Master Reserve Fund receives payments from lenders who have SBA-guaranteed loans and makes payments to the investors in the secondary market program. In fiscal year 2002, SBA estimated that there was a potential future deficit (shortfall resulting from payments to investors exceeding payments from lenders) in the range of zero to $18.3 million required to liquidate the obligations in the 7(a) secondary market. This potential deficit contrasted with fiscal year 2001 where an estimated excess of $68 million was reported.

According to SBA's auditor, SBA used samples of Master Reserve Fund activity for fiscal years 2002 and fiscal year 2001 to estimate the year-end balances. The samples were small and differed in important respects from the total population of loans. Thus, the sampling was not entirely representative of the loan population and did not provide sufficient evidence that the estimate of the Master Reserve Fund balance was fairly stated.

[14] The secondary market program was created to increase the attractiveness of small business lending to the lending community. Through this market, lenders are able to sell the guaranteed portion of SBA guaranteed loans to investors, thereby improving the lenders' liquidity and increasing the yield on the nonguaranteed portion of the SBA loan.

Internal Control Weaknesses

The study and evaluation of the system of internal control over financial reporting are included as part of the financial statement audit under generally accepted auditing standards. Internal control is an integral component of an agency's management that provides reasonable assurance that the following objectives are being achieved: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.[15] Internal control serves as the first line of defense in safeguarding assets and in preventing and detecting errors and fraud. As federal policymakers and program managers continually seek to better achieve agencies' missions and program results, they seek ways to improve accountability. A key factor in achieving these outcomes and minimizing operational problems is the implementation of appropriate internal control.

Internal control over financial information is evaluated during the audit, and the auditor is required to communicate to the agency any condition that represents a significant deficiency in internal controls—referred to as a reportable condition.[16] A material internal control weakness is a reportable condition that does not reduce to a relatively low level the risk that errors, fraud, or noncompliance involving significant amounts may occur and not be detected in a timely manner by employees in the normal course of performing their assigned functions. SBA's auditor identified five material weaknesses and one reportable condition.

As I previously stated, SBA received a disclaimer of opinion from its auditor in fiscal year 2002 primarily due to three issues, and each of these issues resulted from a material weakness in their internal controls. SBA's auditor reported material weaknesses relating to (1) disaster loan modeling, (2) the liability for loan guarantees and related accounts for pre-1992 loan commitments, and (3) the Master Reserve Fund, all of which I have discussed. The fourth material weakness related to SBA's financial reporting process. According to SBA's auditor, SBA continued to experience widespread difficulties in producing complete, accurate, timely, and adequately supported draft and final financial statements, including

[15] *Standards for Internal Control in the Federal Government*, (GAO/AIMD-00-21.3.1) Washington, D.C.: November 1999)

[16] A reportable condition is a significant deficiency in the design or operation of internal controls that could adversely affect the organization's ability to provide reasonable assurance on the reliability of its financial reporting, performance reporting, and compliance with laws and regulations.

footnotes. The auditor stated that additional attention is needed to ensure that a fully effective quality assurance process is documented and in place. The auditor further stated that SBA's difficulties with financial reporting may be attributable to devoting insufficient resources to the process, particularly the quality control process.

The fifth material weakness was due to funds control weaknesses. For example, the auditor reported that SBA established invalid undelivered orders in its liquidating funds and did not return all unobligated balances in its liquidating funds to the general fund at the end of the fiscal year. Also, SBA did not have sufficient funds controls in place to ensure that payments for defaulted 7(a) loan guarantees did not exceed authorized amounts or to ensure that obligations were not incurred against anticipated budgetary resources. These shortcomings increase the risk that SBA may violate the Antideficiency Act.[17]

Finally, while SBA has continued to improve internal controls over its information system environment in certain areas, the auditor reported that further improvement is needed to ensure a sound information system control environment. This internal control deficiency was included as a reportable condition in the auditor's 2002 report on internal controls. Weaknesses were reported in all six categories of general computer controls.[18] General computer controls create the environment in which application systems and controls operate. During a financial statement audit, the auditor focuses on general controls for the agency's major computer facilities and systems supporting a number of different computer applications, such as major data processing installations or local area networks. If general computer controls are weak, as is the case at SBA, they severely diminish the reliability of controls associated with individual applications.

[17] The Antideficiency Act, among other things, prohibits the making of expenditures or the incurring of obligations prior to or in excess of appropriations.

[18] The six general control categories are: (1) entity-wide security program control, (2) access control, (3) application software development and program change control, (4) system software control, (5) segregation-of-duty control, and (6) service continuity control.

Federal Financial Management Improvement Act of 1996

SBA's auditor also concluded that SBA's systems did not substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA). FFMIA is a measure of an agency's ability to incorporate into its financial management system accounting standards and reporting objectives established for the federal government, so that all assets, liabilities, revenues, expenses, and the full costs of programs and activities can be consistently and accurately recorded, monitored, and uniformly reported. Substantial noncompliance with FFMIA indicates that SBA's financial management systems do not routinely provide reliable, useful, timely, and consistent information to fulfill its responsibility of being accountable to the public and of providing timely financial information to manage on a day-to-day basis.

SBA's financial management systems in fiscal year 2002 did not substantially comply with all three aspects of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, or (3) the U.S. government standard general ledger (SGL) at the transaction level.

SBA's auditor noted that SBA was not in substantial compliance with federal financial management systems requirements because its core financial system is not able to provide complete, reliable, timely and consistent financial information on programs to enable management to fulfill its responsibility to the public and to provide timely information for managing current operations. Also, access control, segregation-of-duties, and other general control weaknesses exist in SBA's information systems controls. Additionally, funds control deficiencies exist as is evidenced in SBA's material weakness in that area.

The auditor concluded that SBA did not substantially comply with federal accounting standards because it cannot support the reported cost of loans sold, the reestimates of the subsidy for loans not sold, or the liability for pre-1992 loan guarantees. SBA also cannot support the balance in the Master Reserve Fund.

Finally SBA's auditor concluded that SBA's financial systems did not substantially comply with the SGL at the transaction level. During fiscal year 2002, SBA modified its Financial Reporting Information System but did not detect in a timely manner an error created by the modification. SBA also experienced problems that resulted in the posting of invalid information to the system when it converted to its current Oracle-based administrative accounting system.

In closing, Mr. Chairman, SBA's financial management deficiencies are quite severe and point to an inability to provide full accountability for taxpayer funds provided to the agency for carrying out its programs. Until these deficiencies are corrected, SBA's financial accounting and budgetary reporting will be unreliable. In our January 2003 report, we made a number of recommendations to SBA covering these matters related to accounting for loan sales. SBA agreed with our recommendations, and we understand that they are making progress identifying potential causes of these deficiencies and actions to address them. We look forward to assessing the results of these activities.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other members of the subcommittee may have.

Contact and Acknowledgments

For information about this statement, please contact Linda Calbom, Director, Financial Management and Assurance, at (202) 512-9508, or Julia Duquette, Assistant Director, at (202) 512-5131. You may also reach them by e-mail at calboml@gao.gov or duquettej@gao.gov. Other individuals who made key contributions to this testimony include Marcia Carlsen and Lisa Crye. Numerous other individuals made contributions to the work supporting this testimony.

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Mr. PLATTS. And before we go to our next testifier, I apologize. I wanted to recognize our vice chair, the gentlelady from Tennessee, Marsha Blackburn. Thank you for being with us.

STATEMENT OF THOMAS A. DUMARESQ, CHIEF FINANCIAL OFFICER, SMALL BUSINESS ADMINISTRATION

Mr. DUMARESQ. Chairman Platts, Mr. Towns and other members of the subcommittee, first of all, I apologize for my voice. I woke up, and it seems to have gone away.

On behalf of the SBA and Administrator Barreto, I want to thank you for the opportunity to speak today about the SBA's financial statements. I am Tom Dumaresq, SBA's Chief Financial Officer.

First, I want to emphasize that Administrator Barreto is committed to good and sound financial management. He changed the leadership team in the Office of the Chief Financial Officer because he determined that a fresh look at the agency's financial systems and procedures was necessary. Shortly after he was confirmed, he became aware of problems with the timeliness and accuracy of financial data, the progress of the implementation, and appropriateness of expenditures on a loan monitoring system and issues surrounding loan asset sales. I was appointed CFO in March 2002 with a mandate from the Administrator to correct these problems. Jennifer Main, a senior management consultant and former employee of the Office of Management and Budget with extensive Credit Reform Act experience, was hired as the new Deputy CFO in September 2002.

With the support of Administrator Barreto, the new CFO team quickly identified the primary financial management problems that is the subject to this hearing as well as other critical financial management issues. We were working to address these issues before the GAO fiscal year 2002 audit reports were issued, and I am very confident based on progress so far that the three issues that form the basis of the disclaimer will be resolved before the fiscal year 2003 financial statements are submitted.

SBA IG has the responsibility for obtaining an independent audit of SBA's financial statements annually. Since 1991, the IG has employed Cotton & Co. LLP as its auditor. Since 1996, SBA had been given unqualified opinions from the auditors. We are here today because SBA received a disclaimed opinion on its fiscal year 2002 statements. I would point out, however, that the key issues raised in the fiscal year 2002 audit have been elements of SBA's financial statements since 1999, and only this year did the auditor determine that these issues merited the disclaimed opinion. It is not SBA's treatment of these issues that has changed, but rather the auditor's perspective regarding their significance.

We agree with the auditors' recommendations; however, it is important to recognize that the changed audit opinion does not reflect a decline in the quality of our financial statements, but rather a more in-depth assessment by the auditor of what has been in our financial statements for a number of years. The asset sale issue is very complex, and the available guidance is very limited. It is fair to say that both the fiscal year 2002 financial statement audit and the January 2003 GAO audit provided helpful information, but ul-

timately we recognize that the answer to the problem will come from the CFO staff supported by a highly qualified team of outside consultants.

SBA has been aggressively pursuing an answer to this problem since the fall of fiscal year 2002. SBA held its first asset sale in August 1999. Since then, SBA has conducted a total of seven asset sales and plans to continue the program, but only if it is determined to be in the government's best interest.

As early as the fall of fiscal year 2000, SBA was aware that the accounting for the asset sales was resulting in losses on the financial statements rather than gains as calculated under the asset sales model. In 2001, GAO was asked to look at this anomaly, which resulted in their January 2003 report.

There are two distinct issues that SBA is working to resolve. The first issue is discrepancy between the accounting system which tracks program costs and the budget models which are used to forecast the lifetime loan program cost. The second issue is the discrepancy between the asset sales hold model, which estimates the value to government of loans to be sold, and the budget model. Results from our asset sales program have indicated that while the sales were profitable when measured against the hold model value estimates, the proceeds from the sale caused an increase in program costs as measured by the budget model.

We believe we have made good progress in resolving these issues, but it's too preliminary to go into detail about our findings. I can say that SBA is determined that going forward there must only be one model. The single model must have the functionality to provide both the traditional budget results as well as the loan level value to government estimates that the hold model had provided previously.

Although we have made significant progress, we will not be able to determine the impact of asset sales on the cost of the disaster loan program until the new baseline subsidy model is completed and validated. We anticipate completion of the model, including review and validation, by the end of this fiscal year.

In conclusion, I can assure you that SBA is taking the necessary steps to address the issues raised by GAO and the auditor and expects to have them resolved by the time the fiscal year 2003 audit is completed. I believe that we have learned a great deal as we work through the asset sale issue. We hope to work with OMB and GAO to share our experience with our agency involved in asset sales.

Thank you, and I'm happy to answer any questions.

Mr. PLATTS. Thank you, Mr. Dumaresq.

[The prepared statement of Mr. Dumaresq follows:]

Testimony of

Thomas A. Dumaresq

Chief Financial Officer

U.S. Small Business Administration

Before

Subcommittee on Government Efficiency and

Financial Management

Committee on Government Reform

U.S. House of Representatives

April 29, 2003

Good afternoon Chairman Platts, Ranking Member Towns, and the rest of the subcommittee. On behalf of the U.S. Small Business Administration (SBA) and Administrator Barreto, I want to thank you for the opportunity to speak today about SBA's financial statements. I am Tom Dumaresq, SBA's Chief Financial Officer (CFO).

NEW CFO TEAM

Soon after Hector Barreto was sworn in as Administrator in July 2001, he became concerned about a number of issues regarding SBA's financial management even though the Agency had been receiving clean audit opinions. These issues included the timeliness and accuracy of financial data, the slow progress of the implementation of a loan monitoring system and the appropriateness of the expenditures, as well as issues surrounding loan asset sales. The asset sales issue is the subject of the Government Accounting Office's (GAO) report that they will be discussing here today.

Administrator Barreto is committed to improving the Agency's financial performance and he determined that in order to address these concerns effectively, a change in leadership was needed in the Office of the Chief Financial Officer (OCFO). In March 2002, I was named CFO. Jennifer Main, a senior financial management consultant and former employee of the Office of Management and Budget (OMB) with extensive credit reform act experience, was hired as the new Deputy CFO in September 2002.

I have been with SBA since 1977 in a variety of positions including direct program delivery, policy development and implementation, and most recently, extensive experience with the management and administration of the Agency's internal activities. Before becoming CFO, I had worked on various aspects of major Agency initiatives related to financial management including asset sales, loan monitoring, and implementation of a new administrative accounting system.

My management team's objective is to systematically identify and resolve problems associated with a number of longstanding issues related to the Agency's financial operations. We believe these are the critical steps to ensuring the OCFO's capacity to successfully deliver on its responsibility for sound financial management.
We are here today because SBA received a disclaimed opinion on its FY 2002 financial statements. From 1996 through 2001, the auditor issued unqualified opinions on SBA's financial statements. It is important to understand that the key issues that were raised in the FY 2002 audit have been elements of SBA's financial statements since 1999 and only this year did the auditor determine that these issues merited a "disclaimed" opinion. **It is not SBA's treatment of these issues that has changed, but rather the auditor's perspective regarding their significance. We generally agree with the auditor's recommendations.** However, we think it is important to note that **the changed audit opinion does not reflect a decline in the quality of our financial statements but rather a more in-depth assessment by the auditor of what has been in our financial statements for a number of years.**

Upon assuming the duties of CFO, I became aware of a number of challenges that needed to be addressed immediately. Several of these issues were related to the implementation of a new administrative accounting system based on software from Oracle Corporation. This system is called the Joint Accounting and Administrative Management System (JAAMS). In the second half of FY 2002 and the first quarter of FY 2003, significant resources were allocated to resolving implementation problems with this system. As a result, the Agency was able to complete installation of this new system and produce financial statements in a timely manner. This is a significant achievement that would not have happened without extraordinary efforts by the staff in the office of the CFO as well as the participation and cooperation of the Office of the Inspector General (IG) and our auditor.

During the same period that we were addressing the JAAMS challenges, I became aware of the extent of the issue of SBA's budgeting and accounting for asset sales. As you know, this issue was the principal cause for the auditor's withdrawal of its unqualified opinion for SBA's FY 2000 and FY 2001 financial statements. Subsequently, the FY 2002 financial statements (as well as the FY 2001 statements) received a disclaimed opinion again primarily because of the same asset sale issue, as well as two other items. I want to assure you that SBA was aware of the situation and had been taking steps to address it prior to the auditor's disclaimed opinions and the GAO report.

LOAN ASSET SALE ISSUE

SBA held its first asset sale in August 1999. Since then, SBA has conducted a total of seven asset sales and plans to continue the program if it is in the government's best interests. As early as the fall of FY 2000, SBA was aware that the accounting for the asset sales was resulting in losses on the financial statements rather than the gains calculated under the asset sales model. The former OCFO management was not able to resolve this apparent inconsistency.

In 2001, GAO was asked to review the loan asset sale program, and a report was published in January, 2003. Overall, SBA agreed with GAO's findings regarding the budgeting and accounting for asset sales, and we have made substantial progress in identifying and sorting out the underlying problem in the past few months. Before I discuss the actions we are taking, however, I want to make a few general points about this issue.

It is important to note that this area is not an area where extensive guidance has been developed. The guidance that exists from the OMB, the Federal Accounting Standards Advisory Board (FASAB), and others is relatively general in nature and requires interpretation for specific application. Throughout its loan asset sales program, SBA repeatedly sought outside experts recognized in this field to help interpret and apply the available guidance. The emergence of these difficult issues despite the professional advice SBA received underscores the complexity of the problem.

RESOLUTION OF THE ASSET SALE ISSUE

There are two distinct issues that SBA is working to resolve. The first issue is the discrepancy between the accounting system, which tracks program costs, and the budget models, which are used to forecast the lifetime loan program costs. Under the Federal Credit Reform Act, the "cost" estimated by the budget models should exactly cover the cost of the program as tracked through the accounting system. This has not been the case, however, for the Disaster loan program, which has made up the majority of the loans sold in the asset sales program. Resolving this "anomaly" – and understanding the extent to which asset sales contributed to it – has been our first priority.

The second issue is the discrepancy between the assets sales "hold model" which estimates the "value to government" of loans for sale and the budget model, which is used to measure the net budget impact of all loan payment events, including loan sales. Results from our asset sales program have indicated that, while the sales were profitable when measured against the hold model value estimates, the proceeds from the sales caused an increase in program costs as measured by the budget model.

Although readily apparent for several years, the inconsistencies between the hold value model, the subsidy model, and the financial statements were never sufficiently addressed. This is a complex problem and a somewhat new concept, and despite SBA's efforts to follow all applicable guidance in budgeting and accounting for asset sales, we recognize that the results of the process were inadequate.

Ultimately, responsibility for pursuing the resolution of these inconsistencies clearly rests with SBA. The new CFO management team is committed to resolving this issue. SBA believes we have found the root cause of the problem, and the issue will remain a top priority of the Agency until it is fully remedied.

SBA has worked aggressively to get to the bottom of these issues since last fall. During the audit process, we worked with our auditor to analyze the potential causes of the inconsistencies and identify options for resolving the situation. In January, we added a team of experienced credit reform accountants and budget analysts from IBM to work with OCFO staff.

Our analysis resulted in a number of key findings regarding SBA's accounting and subsidy methodology. The findings are preliminary and therefore it would be premature to discuss them today. However, I can say SBA has determined that going forward there must be only one model for budgeting and loan sale purposes. The single model must have the functionality to provide both the traditional budget results as well as the loan level value-to-government estimates that the hold model had provided previously. We believe this is the only way that SBA can ensure that the value-to- government calculation is entirely consistent with the budget cost estimate.

We have begun building a new budget subsidy model prototype. However, we will not be able to determine the impact of asset sales on the cost of the Disaster loan program until the new model is developed, tested and verified. We anticipate completion of the model, including review and validation, by the end of this fiscal year. SBA believes it will have valuable lessons learned to share with other Federal agencies.

OTHER AUDIT ISSUES

Next, I want to briefly mention SBA's efforts to address the other issues identified by our auditor. The SBA's assessment and treatment of the Master Reserve Fund (MRF) residual liability was identified in our FY 2002 audit process as contributing to the disclaimed opinion. For the secondary market component of the 7(a) program, SBA's Fiscal and Transfer Agent (FTA), Colson Services Corporation, maintains the MRF to ensure that investors receive their monthly payments of principal and interest in a timely manner. Should the fund ever have a shortfall, the SBA would have to step in to cover the gap. SBA's auditor has criticized SBA's ability to measure whether the MRF is adequately capitalized. From OCFO's perspective, the primary challenge to SBA's ability to measure the capitalization is hampered by the lack of data. We will be working with the FTA in the coming months to determine what cost effective alternatives are available to address this problem. At a minimum, we plan to develop a more sophisticated methodology for measuring the residual liability in the MRF for FY 2003.

Also included was SBA's treatment of pre-1992 loan guarantees, the financial reporting process, and funds control weaknesses. We are taking action to address each of these

issues and believe these items are things that SBA can successfully resolve prior to completion of the FY 2003 financial statement process.

CFO RESPONSIBILITY'S

I'd like to discuss SBA's broader financial management issues next. With the Chief Financial Officer's (CFO) Act of 1990, the Congress mandated financial management reform and entrusted the responsibilities of sound financial management and accountability with the CFO at each designated Agency. More recently, President Bush, under his Management Agenda (PMA), also highlighted financial management as a key area in improving the management of government resources. The PMA standards of success include requiring the agency good quality financial data in day to day operations and a clean audit.

Reflecting the objectives of the CFO Act and President Bush's agenda, the mission of the SBA Office of the CFO (OCFO) is to use our personnel, processes, and systems to achieve sound financial management and to produce accurate, timely, and useful information that can – and should -- be used to support operating, budget, and policy decisions.

It is in this context that we have identified and are focused on three key objectives:

1 – Build trust, both internally and externally;

2 – Focus on and succeed at activities that are core to our mission; and

3 – Improve data quality.

The OCFO's approach to accomplishing its objectives involves addressing and solving the current challenges while building the capacity to make meaningful improvements in the underlying systemic problems facing the office. SBA is not only addressing the three issues identified specifically as contributing to the "disclaimer" in the FY 2002 audit but is also hard at work on a variety of other items that were raised in the auditor's internal controls report as well as other matters that we believe may affect our capacity to fulfill our core functions.

Through the SBA-wide Execution Scorecard system developed by the Deputy Administrator, the OCFO has established meaningful but manageable size projects that will lead us to success in each of the current issues listed above. The OCFO and SBA leadership are tracking these key projects through the use of specific milestones, deadlines, and budgets. The OCFO meets monthly with the Deputy Administrator to discuss progress and ensure we are on target. These include challenges that virtually all Federal government CFOs are facing: technology, human capital, information management, performance measures, and performance-based costing.

While SBA acknowledges that it still needs to make progress in all of these areas, SBA's view is that bringing these important financial management and reporting issues to light

so we can resolve them is a positive step forward for the Agency. We believe we are on track to substantially improve the overall financial performance results at SBA this year. SBA is strongly committed to addressing all of the issues raised by our auditor and GAO and resolving them in this audit year.

Thank you and I am happy to answer any questions you may have.

Mr. PLATTS. Mr. McClintock.

STATEMENT OF PETER McCLINTOCK, DEPUTY INSPECTOR GENERAL, SMALL BUSINESS ADMINISTRATION

Mr. MCCLINTOCK. Good afternoon, Chairman Platts, Mr. Towns, Mrs. Blackburn.

Your letter of invitation asked me to address five issues, which I will do. You asked for our reaction to the findings in the GAO report. In brief, the GAO report identified significant issues which may have affected the fair presentation of SBA's fiscal year 2000–2001 financial statements.

Of the issues identified, we believe the disaster loan subsidy model's shortcomings have the greatest impact on SBA's financial statements. The subsidy estimate and reestimates prepared by SBA directly and indirectly affect all of the accounting anomalies noted.

GAO recommended that we and our financial statements auditors assess the impact of identified misstatements and determine whether previously issued audit opinions need to be revised. We agree with GAO's recommendations. From our preliminary assessment of actions to date, it appears that SBA is taking appropriate steps to correct the problems. However, much work remains, and it always has to be reviewed.

You asked for our reaction to the issuance of a disclaimer of opinion by our auditors on the 2002 financial statements and the withdrawal by the auditors of their opinions for the 2000 and 2001 statements. Based on the lack of information to verify certain financial statement amounts, we believe that a disclaimer was appropriate for the 2002 audit. Regarding the 2000 and 2001 statements, Cotton & Co. withdrew its opinions based on the findings in the GAO's report and the resulting uncertainty of some of the financial statement amounts. We agree with Cotton's decision to withdraw their opinions and ensure that SBA made appropriate disclosures.

The subcommittee also asked for our reaction to the scoring of SBA's financial management for 2002 and 2001 in the President's Management Scorecard. While not familiar with all the details for scoring, we believe the 2002 score of red was appropriate. SBA's 2002 appears to be directly related to Cotton's disclaimer of opinion. In 2001, SBA received a yellow score. While SBA had received a clean opinion in 2001, Cotton noted material weaknesses and reportable conditions in SBA's reporting process and related system controls. Also, for both years, SBA was not in substantial compliance with the Federal Financial Management Improvement Act of 1996. These problems appear to meet the criteria for a red score.

You asked how the OIG is responding to these problems. We have worked closely with Cotton and the CFO to ensure that the correct process was followed in withdrawing past opinions. We also initiated a review to understand the process that had been used in the past for loan sales accounting. This review is ongoing.

We have also taken steps to strengthen the audit process. First, we asked Cotton for a plan for the 2003 audit with specific emphasis on credit reform. Cotton's plan includes retaining additional credit reform expertise, increasing involvement by one of their

partners with recognized credit reform experience, and retaining an outside expert to review their credit reform testing.

Second, we are increasing our monitoring of the financial statement audit. To strengthen our own credit reform knowledge, we have enlisted the help of GAO to guide us in monitoring the credit reform aspects of the audit, and we will train appropriate OIG staff in Federal credit reform accounting.

Third, the CFO, Cotton and OIG will form a working group to have open and candid discussions about audit issues as they arise.

Last, the SBA Administrator recently decided to create an audit committee for the agency to advise and oversee financial management within SBA.

You asked us to identify the challenges SBA faces to improve financial management. SBA faces a number of challenges. Its loan accounting system has been in use since the 1970's and is programmed in COBOL. SBA incurs substantial risk because the system is close to the end of its useful life, and it faces loss of contractor support within the next few years. Further, the system cannot be easily modified to adapt to accounting changes and rules. In fiscal year 2002, Cotton identified financial system information security weaknesses related to authorization, completeness, accuracy and integrity of processing data files. While SBA has made substantial progress in this area over the years, this area requires continued vigilance.

In October 2001, SBA implemented the Joint Accounting and Administrative Management System [JAAMS]. While JAAMS has some improved features, it does not fully support the U.S. Standard General Ledger, and it does not provide for integration of SBA's disparate accounting systems. SBA has recognized that JAAMS does not fully meet its needs and is looking for alternatives.

SBA continues to rely heavily on its Financial Reporting Information System [FRIS]. FRIS consolidates the results of various accounting systems and generates the financial statements. FRIS consists of a number of automated and manual processes. This process has yet to result in SBA producing timely, accurate and complete financial statements.

In summary, many of the SBA financial reporting problems are related to outdated and cumbersome systems.

Again, thank you for the opportunity, and I'd be pleased to answer any questions you have.

Mr. PLATTS. Thank you.

[The prepared statement of Mr. McClintock follows:]

Testimony of

Peter L. McClintock

Deputy Inspector General

U.S. Small Business Administration

Before

Subcommittee on Government Efficiency and

Financial Management

Committee on Government Reform

U.S. House of Representatives

April 29, 2003

Good afternoon Chairman Platts, Congressman Towns, and members of the Subcommittee. I appreciate the opportunity to appear before you today to discuss the status of financial management at the Small Business Administration (SBA). Your letter of invitation requested that I address specific topics. This testimony is structured to respond to each topic identified.

U.S. General Accounting Office Report, *"Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain."*

The General Accounting Office's (GAO) report GAO-03-87, "*Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain,*" identified significant issues in SBA's accounting and budgeting for loan sales which may have affected the fair presentation of its fiscal year 2000 and 2001 financial statements. Accordingly, GAO

recommended that the Inspector General, in conjunction with SBA's financial statement auditors, assess the impact of any identified misstatements in the financial statements and determine whether previously issued audit opinions for fiscal years 2000 and 2001 need to be revised. Further, GAO made several recommendations to SBA's Administrator to provide accurate and reliable information about how the sales affect SBA's financial statements, budget, and operations. We agree with both the recommendation addressed to our office as well as those recommendations addressed to the Administrator.

Of the issues identified by GAO, we believe the disaster loan subsidy model shortcomings have the greatest impact on SBA, its reported financial results, and its ability to fulfill its mission. The subsidy estimates and re-estimates prepared by SBA directly or indirectly affect all the accounting anomalies noted by GAO. Based on the preliminary results of work performed by SBA and its contractor on these issues, it appears that the subsidy model for the disaster loan program needs to be modified to more accurately reflect disaster loan program costs. We agree with GAO that the errors and lack of appropriate analyses related to the disaster subsidy model mean that SBA and congressional decision makers are not receiving accurate financial data that they need to make appropriate decisions regarding SBA's programs and budget. From the preliminary assessment of the work SBA is doing to overcome these shortcomings, it appears that SBA is taking appropriate steps to ensure it can produce reliable disaster subsidy estimates and re-estimates in the future. However, until SBA completes its work in this area to identify the financial impact and the results are independently reviewed, we cannot provide any assurance that the results will address all of GAO's concerns.

Audits of SBA's Financial Statements for Fiscal Years 2000, 2001, and 2002

SBA's independent public accountant, Cotton & Company LLP (Cotton), issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. A disclaimer of opinion means that the auditors were unable to express an opinion on the financial statements due to limitations on the scope of their work. Cotton noted scope limitations in the areas of disaster loan program modeling, pre-1992 loan guarantees, and the Master Reserve Fund residual liability. In the area of disaster loan modeling, SBA had not fully assessed the impact of the issues noted by GAO; therefore, SBA was unable to determine what corrections were required to the fiscal year 2002 financial statements. Due to this uncertainty and the lack of evidence that showed the current disaster loan models produced accurate results, Cotton could not satisfy themselves as to the accuracy of related financial statement amounts. Regarding pre-1992 loan guarantees, SBA was unable to provide sufficient documentary evidence needed to satisfy Cotton that Liabilities for Loan Guaranties and related accounts were fairly stated. The Master Reserve Fund (MRF), which is used to facilitate operation of the Section 7(a) secondary market program, is also reported in SBA's financial statements. However, SBA used small, judgmental samples of MRF data to estimate the long-term excess or deficiency of MRF earnings over expected payments. The resulting estimates were statistically unsupported and may not be reliable. Based on our discussions with Cotton and our review of the work they performed, we believe that a disclaimer was the most appropriate result for the fiscal year 2002 audit.

On December 20, 2002, Cotton notified SBA and our office that SBA's financial statements for fiscal years 2000 and 2001 should no longer be relied upon due to "the possibility that material adjustments may be necessary for disaster loans sold, disaster loan subsidy expense, and other directly related accounts and footnotes corresponding to SBA's disaster loan program." Cotton withdrew its opinions on these statements based on the findings in GAO's report and the resulting uncertainty of many financial statement amounts. We agree with Cotton's decision to withdraw these opinions and their efforts to ensure that SBA made the appropriate disclosures to all parties who rely on SBA's financial statement information. As SBA moves forward with determining the magnitude of any misstatements in its financial statements, it will be necessary to assess whether SBA needs to restate its 2000 and 2001 financial statements or whether SBA's fiscal year 2002 and 2003 comparative financial statements should present the cumulative results of any errors. We will work with all interested parties, including GAO and OMB, to make this determination. Any corrections and adjustments that SBA makes, either as restatements to previous year financial statements or as corrections of errors in the current year financial report, will be validated by Cotton.

The issues noted by GAO and Cotton in its fiscal year 2002 audit increase the risk regarding SBA's ability to produce auditable financial statements for fiscal year 2003. SBA is required to prepare comparative financial statements for fiscal year 2003. In order to receive an unqualified opinion on those financial statements, SBA must complete its assessment of the necessary modifications to the disaster loan subsidy model, redesign and test the model as needed, quantify any errors, and correct the financial statement

accounts for both fiscal years 2002 and 2003 in adequate time to be audited. SBA has identified many of the problems and has performed some of the work to rebuild the subsidy models. However, there will be very tight timeframes to complete the required tasks in time for proper quality assurance and for Cotton to perform their procedures. These timeframes are further complicated by SBA's plans to accelerate its reporting process this year to prepare for the aggressive fiscal year 2004 reporting timetable. While we believe that it is crucial for SBA to begin accelerating its financial reporting process, we also should recognize the additional risks that are likely to occur so these risks can be mitigated. As a result of our concerns, we have been in discussions with SBA's Office of Chief Financial Officer (OCFO) and have a verbal commitment from them that Cotton can perform as much of their test work as possible while SBA is in the process of correcting its disaster subsidy model problems. Cotton will be able to provide OCFO feedback as the process moves along and OCFO should be able to address any shortcomings noted by Cotton in ample time to prepare auditable financial statements.

SBA's 2002 Scoring in the President's Executive Branch Management Scorecard

We believe the scoring of SBA's financial management performance for fiscal year 2002 in the President's Executive Branch Management Scorecard is appropriate. One of the key factors used by OMB in its Scorecard for an agency to get a score of "green" in financial management is to receive an unqualified opinion on its financial statements. We believe OMB's lowering of SBA's score for its fiscal year 2002 financial performance was directly related to Cotton's disclaimer of opinion. However, it may have been appropriate for SBA to have received a "red" score in 2001. While SBA had

received a clean opinion on its financial statements (since withdrawn) and a score of "yellow" on the OMB Scorecard, Cotton noted in fiscal year 2002, and over the past several years, material weaknesses[1] and reportable conditions in SBA's financial reporting process and information system controls related to financial management activities. In addition, Cotton noted in fiscal years 2001 and 2002 that SBA was not in substantial compliance with the Federal Financial Management Improvement Act of 1996. These problems appear to meet the criteria for a "red" score. Accordingly, we believe that emphasis should be placed on material weaknesses, reportable conditions, and noncompliance with financial related laws and regulations noted by auditors in assessing the adequacy of an agency's financial management.

Actions Taken to Respond to the Credit Reform Issues Identified by GAO

OIG has taken several actions to respond to the issues identified in the GAO report, both reactive as well as proactive. Upon learning of the issues identified by GAO in their audit report, we met with Cotton to discuss the potential impact on prior year audit opinions. Cotton concluded that material adjustments may be necessary for disaster loans sold, disaster loan subsidy expense, and other directly-related accounts and footnotes for the fiscal years 2000 and 2001 financial statements. As a result, our office worked with Cotton and OCFO to ensure that applicable auditing standards governing a subsequent discovery of facts existing at the date of the auditor's report were both understood and

[1] Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level of risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

met by both parties as they apply to this matter. Additionally, our office initiated a review to understand the process that had been used in the past concerning the accounting for loan sales. This review is ongoing.

While we continue to work with SBA management to determine the impact of the issues on SBA's financial results, we have also taken steps to strengthen the audit process to increase the likelihood that these types of issues will be recognized and addressed during future audits. First, we have asked Cotton to provide us with a plan which details their approach and proposed staffing for the fiscal year 2003 audit with specific emphasis on the credit reform aspects of the audit. Cotton has provided a plan for the fiscal year 2003 audit which includes retaining additional experienced credit reform experts to complement their existing credit reform resources, increasing involvement by one of their partners with recognized credit reform experience, and retaining an outside expert to review their credit reform testing.

Second, we have increased our monitoring and oversight of the annual financial statement audit. During fiscal year 2002, we improved our monitoring procedures in assessing the quality of Cotton's work. We also hired a senior auditor with financial audit experience and knowledge of federal accounting policies and procedures to assist in monitoring the annual financial statement audit. Further, we strengthened our oversight role and increased our knowledge of SBA's operations and systems by accompanying Cotton on many of their district office visits during the internal control phase of the fiscal year 2002 audit. We also performed some of the information systems internal control

testing work in-house. While we acknowledge our progress in this area, we also recognize our weakness when it comes to our knowledge in the credit reform area. We plan on addressing this issue in the following two ways. We have elicited the help of the GAO to assist us in monitoring the credit reform aspects of the audit. Additionally, we will invest the time and resources to ensure that the appropriate OIG staff are trained and certified in federal credit reform accounting.

Third, we continue to strengthen our working relationship with SBA's OCFO to ensure that the issues in the credit reform area as well as SBA's overall financial reporting process are resolved in the most efficient and effective manner. For example, for the fiscal year 2003 audit, SBA's OCFO, Cotton, and our office will form an audit working group where all parties will participate in open and candid discussions about audit issues that arise during the audit as well as ideas for improving SBA's overall financial management.

We also endorse the Administrator's recent commitment to create an Audit Committee to advise and oversee financial management activities at SBA. We believe the addition of an Audit Committee is an opportunity to bring added voices of expertise to the improvement of SBA's financial management operations and internal control system. The Audit Committee will highlight those issues that deserve management's attention, provide counsel on possible courses of action, and assist in resolving audit recommendations. We support the use of an Audit Committee and will work closely with

the Administrator and Chief Financial Officer to identify the role and responsibilities of such a committee.

Challenges and Opportunities for Improving Financial Management at SBA

SBA faces a number of significant challenges for improving financial management and performance which are affected by the Loan Accounting System (LAS), the lack of a fully functioning integrated financial reporting system, and information system control weaknesses. SBA relies on LAS to account for and report on different aspects of SBA's loan portfolio. LAS, which has been in use since the 1970's, is comprised of approximately nine subsystems and is programmed in COBOL computer language. SBA incurs substantial risk relating to the continued use of LAS because it is close to the end of its useful life and SBA faces the loss of contractor support for the system within the next few years. Further, LAS cannot be easily modified to adapt to changes in accounting rules.

In fiscal year 2002, Cotton identified information security weaknesses in SBA's financial management system application controls related to authorization, completeness, accuracy, and integrity of processing data files. While SBA has made progress in improving its information security controls, this area requires continued vigilance to ensure that cyber security risks and threats which may disrupt business operations or lead to unauthorized access of important proprietary and other restricted information are reduced to a manageable level.

SBA continues to have difficulty implementing an accounting system that can produce timely, accurate and complete financial information. In October 2001, SBA implemented the Joint Accounting and Administrative Management System (JAAMS) to replace a previous mainframe based accounting system. While JAAMS has some improved features over the previous system, it lacks the necessary functionality to fully support the U.S. Standard General Ledger and provide for integration of SBA's many disparate accounting and financial management systems. Due to budgetary constraints, SBA only implemented selected components of the new JAAMS system. We have noted other problems with JAAMS in an ongoing audit relating to its selection, development, implementation, and functionality. While it is premature to discuss the details of those issues at this time, we expect a final report to be issued on or about June 30, 2003, and will provide the Subcommittee a copy of the report at that time. SBA has recognized that JAAMS does not fully meet its needs and is in the process of identifying a contractor that can host the system in a more efficient and effective environment.

SBA continues to rely heavily on its Financial Reporting Information System (FRIS). FRIS was developed in April 2000 to consolidate the results of various accounting systems to generate required financial statements. The system consists of a number of automated and manual processes, which are performed monthly to create a combined general ledger. By design, the combined general ledger data cannot be viewed directly in FRIS. To view this data, users download FRIS data and analyze it using common desktop applications, such as Microsoft Excel. SBA's inability to integrate information from its various financial management systems is a significant barrier to SBA's ability to

produce timely, accurate, and complete financial information for program management and financial reporting.

SBA has the opportunity to ensure that its new systems will provide the agency with a better and more efficient financial reporting process as they address the challenges with its financial management systems. One of these challenges has been that SBA experiences problems with its financial reporting process which result in delays in the preparation of important financial data and clear and understandable audit trails. Many of these financial reporting problems are related to SBA's outdated and inflexible systems. SBA must improve or replace these systems. As it does, SBA will be in a position to reengineer and rebuild its financial reporting process and provide a single integrated system that allows financial records to be readily auditable, thereby providing SBA with real time data for meeting its needs.

Again, thank you for the opportunity to discuss these issues and I would be pleased to answer any questions.

Mr. PLATTS. Mr. Hayward.

STATEMENT OF CHARLES HAYWARD, PARTNER, COTTON & CO.

Mr. HAYWARD. Good afternoon, Chairman Platts and members of the subcommittee. I submitted a written statement of today's testimony, and rather than summarize that statement per se, what I'd rather do is to reformulate my testimony right now in a way that would address the four key points that the committee wants to talk about today. I'll address these points in turn.

First of all, however, I would like to preface my remarks by informing the subcommittee that my input today reflects our assessments as of January 29, 2003. That is the close of our audit field work, and we have not done any substantive audit testing since that date.

Right now I would like to get into your questions, your four questions, and my inputs to those questions as best as I can. The subcommittee's first question: What are the fundamental flaws with SBA's accounting for loan sales? We've had Pete and Tom speak to that already. I'd just like to say that during the 2002 audit, we learned that shortcomings with SBA's disaster modeling were the basic flaw. Bill Menth will speak in a few minutes about this flaw, which led to two kinds of inaccuracies, neither of which could be readily quantified by management during the relatively short period of the 2002 audit. The first effect of this flaw was that SBA's unsold loans could not be valued correctly, and SBA's subsidy costs for loans not sold could not be accurately reestimated. The second effect of this flaw was that reliable and accurate values for loan sale losses could not be computed. These two effects were embodied in our audit reports, reflected in our disclaimer of opinion, and addressed in greater detail in GAO's report.

SBA has, as I mentioned—has spoken to its evaluation of GAO's report for purposes of assuring itself that all corrective actions are taken as soon as possible and, in any event, in time for Cotton & Co. to adequately assess corrective action. I can only say at this time that SBA's reaction appears consistent with its desire to be responsive to us and GAO.

The subcommittee's second question: What did SBA learn from the consultants it hired to help solve the problems with loan asset sales? I think it's fair to say that it appears to us that SBA has gone a long way toward answering this question in the testimony just given. Bill, I might add, will supplement that point.

I wish, however to make two points. The first point I'd like to make is that some of our audit evidence supporting our clean opinions for 2002 and 2001 was based on our conclusions drawn from reviewing available reports prepared by SBA's credit modeling consultants. These reports found that the subsidy modeling estimates were reasonable and free from material deficiencies, and those reports addressed most or all of the models, particularly the disaster loan model. While the body of our audit evidence with respect to the 2000 and 2001 modeling was broader than these consultants reports, I simply want to make the point that such reports, these consultants reports, did influence our work.

Second, I want to point out that while we have not been privy to the latest report by IBM, we understand that report goes a long way as a positive first step toward the necessary corrective action on SBA's part.

The subcommittee asked a third question: How does SBA plan to rectify the situation and make sustainable long-term improvements to its financial management? Again, I think SBA has done a much better job of addressing this question than I can. I would simply like to say that appearances here today and from the testimony that I've seen indicate that SBA will undertake the necessary actions to rectify this situation and make sustainable long-term credit improvements as soon as it can. Its plans to meet these goals this year are ambitious.

Fourth, why did SBA receive clean opinions in fiscal years 2001 and 2000 when its accounting for loan asset sales was flawed? I'd like to start by saying that credit reform is an extremely complex area involving a number of disciplines'—accounting, modeling, statistics, and economics. Beginning in 2000, the partial cohort asset sales exacerbated those complexities and brought to light the problems so that they were clear to everybody involved here at this table.

In our 2000 and 2001 audits, we recognized that these compounded complexities existed, and we completed extraordinary procedures to test the methodology and the underlying data. Those are the two key steps under audit standards with respect to accounting estimates. The modeling flaws that are now apparent escaped our detection. Many expert eyes have looked at the estimation models and methodologies over the years, and I must say that the flaws that escaped our attention, escaped other persons' detections as well.

But I want to emphasize that the responsibility for our audit opinion is ours and ours alone. With—when the inaccuracies in the estimates became evident last year, I want to also say that we did what was required under the standards. We took steps in cooperation with SBA to prevent continued reliance on the financial statements, and we withdrew—we asked SBA to make clear to potential readers that they should not rely on either our audit opinions for those years or the agency's financial statements.

Now, withdrawing an opinion is not something that the firm took lightly, and we certainly will not take that lightly. We intend to learn from that withdrawal in the future. In doing audits for more than 22 years, Cotton & Co. has never before had to withdraw reliance on an audit opinion, and in this case we've done what we believe to be the right things.

In closing, I hope that is a good start for allowing you to understand our perspective. Thanks for listening, and I'd be happy to answer questions.

Mr. PLATTS. Thank you.

[The prepared statement of Mr. Hayward follows:]

Testimony of
Charles J. Hayward, CPA
Partner, Cotton & Company LLP
Before
Subcommittee on Government Efficiency and
Financial Management
Committee on Government Reform
U.S. House of Representatives
April 29, 2003

Congressman Platts, Congressman Towns, and members of the subcommittee: I appreciate the opportunity to appear before you today to discuss the Small Business Administration's financial statements, and answer your questions. My following statement will briefly cover two topics: Our audits for FYs 2000 to 2002; and, prospectively, enhancing SBA's financial management.

Cotton & Company's audits of SBA's 2000 to 2002 financial statements

SBA's financial statements rely heavily on accounting estimates to approximate both the value of the agency's loan portfolio and the subsidy costs of its several loan programs, by cohort year. These estimates are made by modeling the agency's historical cash flows and other loan data since the inception of the Credit Reform Act of 1990. SBA uses models for estimating its original subsidy costs, and reestimating such costs in each succeeding year. While the models generally are complex, a key premise in SBA's disaster loan models has been that one illustrative loan can serve as an effective proxy for all loans made to individuals, and another illustrative loan can do the same for businesses. When the single-proxy premise was adopted, loan sales were not anticipated.

SBA first began selling its loans during 1999, and commenced large-scale loan sales the following year. The preponderance of loans sold to date has come from SBA's disaster loan portfolio. It is important to mention that SBA appears to be the sole federal agency tasked to date with selling material portions of loan portfolio cohorts, rather than selling entire cohorts. Selling material portions of cohorts leads to substantially greater accountability challenges, because of the need to track subsidy costs by cohort for loans sold and loans kept.

Recognizing the inherent uncertainty in accounting estimates, we performed substantial evaluations during each year's audit of SBA's estimating methods and tested their results. In the audit of SBA's FY 2000 financial statements, we found that book value losses on disaster loan sales were not included in the required disaster loan subsidy cost reestimates. To account for this

cost, we recommended that the financial statements include an imputed subsidy reestimate of $468 million, which was the estimated amount needed to cover these losses as SBA had computed them. SBA accepted this recommendation and recorded an adjustment to its financial statements.

In the audit of SBA's FY 2001 financial statements, we found that cash flow models included (for the first time) the effects of loan sales, but the reestimated subsidy costs derived from the disaster models were substantially smaller than expected based on previous work. To resolve this apparent inconsistency, both SBA and we performed additional analysis of the subsidy estimates. That additional analysis generally confirmed that the estimated subsidy costs were consistent with what was being reported in the financing account.

You asked us to specifically address why SBA received clean opinions on its 2000 and 2001 financial statements when the accounting for loan asset sales was flawed. As others on this panel have already explained more eloquently than I can, credit reform is an extremely complex area. Partial cohort asset sales exacerbated those complexities significantly beginning in 2000. We recognized these compounded complexities, and we did extraordinary procedures to test the methodology and underlying data. The modeling flaws that are now apparent escaped our detection. Many expert eyes have looked at the estimation model and methodologies over the years. Indeed, part of our testing included coordination with and reliance upon those experts. The modeling flaws escaped everyone's detection. But, the responsibility for the audit opinion is ours and ours alone. When the inaccuracies in the estimates subsequently became evident in 2002, we did the right thing. We took steps, with SBA's cooperation, to prevent continued reliance on the financial statements. Withdrawing an audit opinion is not an easy thing to do or something that we take lightly. (In doing audits for more than 22 years, Cotton & Company LLP has never before had to withdraw an audit opinion.) In this case, it was the right thing to do.

During the audit of SBA's FY 2002 financial statements, our work demonstrated that SBA's disaster loan models were not reliable—the single-loan proxy premise became inadequate when substantial loan sales began. It did so because a single proxy loan cannot produce reliable projected cash flows when the:

- Portfolio is diverse.
- Cost of any loan increases with the loan term (terms vary from 1 to 30 years).
- Average term of loans sold is several years longer than that of the original portfolio.

The unreliability of the modeled data raised uncertainties affecting SBA's budgetary and proprietary accountability. These uncertainties involved certain material line items reported on each of the agency's five principal financial statements and related footnote disclosures since the inception of SBA's substantial loan sales in 2000. According to auditing standards, we withdrew our unqualified opinions on the FY 2000 and 2001 financial statements, and we disclaimed an opinion on SBA's most recent comparative financial statements, covering 2001 and 2002.

Enhancing SBA's Financial Management

We understand SBA will be implementing a number of financial management enhancements in support of its goal of improving financial statement reliability. We cannot overstate, however, the value that SBA's "lessons learned" will have for the federal credit reform community at large. Among other "lessons learned," we think SBA can and will convey the importance of testing subsidy models, such that other agencies subject to the Credit Reform Act can timely satisfy themselves that the cash flow models they use for subsidy estimates and reestimates are adequate to account for the cost of loan sales. Other agencies may thereby be able to avoid the difficulties SBA recently has experienced, and preserve their accountability.

SBA can enhance its financial management by implementing the following controls:

1. Assessing the conceptual soundness of subsidy estimation models and rebuilding any models that otherwise may produce unreliable results in the foreseeable future.

2. Ensuring that the documentation requirements of Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, are met.

3. Developing an objectively verifiable estimate for pre-1992 guarantee loan default liability utilizing risk factors in accordance with SFFAS No. 2; maintaining sufficient documentation to support the assumptions in the calculation model; and performing a

thorough analysis to ensure that liquidating fund account balances and account activity are accounted for and presented in accordance with SFFAS No. 2.

4. Assessing whether SBA has devoted sufficient resources to adequately address its current financial reporting shortcomings and determine if the current process will need re-engineering and additional resources to enable SBA to meet accelerated financial reporting deadlines in future years.

5. Performing fluctuation analyses and determining reasons for all material changes in all financial statement account balances to permit inaccuracies that become obvious while performing such analyses to be corrected before submitting draft financial statements.

6. Re-engineering and enhancing its financial-reporting quality control process, to achieve minimum reliability expectations for draft financial statements.

7. Developing and implementing procedures to review obligated and unobligated balances remaining in liquidating funds at the end of the fiscal year, and de-obligating unneeded undelivered orders and returning them to the general fund at the end of each fiscal year.

8. Developing and implementing an integrated funds control system that allots the lesser of apportioned authority or realized resources at the fund and cohort level.

9. Developing and implementing a process to ensure that apportionment amounts are accurately recorded in SBA's GL, which includes documented supervisory reviews as necessary to reasonably assure reliability.

10. Developing a process for estimating SBA's ownership in earnings from the MRF that provides accurate, complete, and timely data for the financial statements.

We understand that SBA began its ambitious plans for improving its controls and systems late last summer—during last year's audit. In brief, the attached exhibit displays where SBA stands regarding implementation.

We expect to monitor SBA's progress during the FY 2003 audit, and will continue to watch for and recommend improvements, where warranted. In addition, we are taking steps to enhance and increase our audit focus in the credit reform aspects of the audit. These steps include adding a high-profile credit reform expert to complement our existing credit reform resources, increased involvement by another one of our partners with recognized credit reform experience (Catherine Nocera, CPA) and identification of an outside expert to "peer review" our credit reform testing. We also have agreed with GAO that we will coordinate more closely with their credit reform experts before the audit is completed. Finally, the SBA OIG plans to provide further support and assistance during the audit.

I will be pleased to answer your questions.

US Small Business Administration
Implementation Status
FY 2002 Reportable Conditions
April 29, 2003

Action Needed	Planned Action	SBA's Target Completion
1. Assess the conceptual soundness of subsidy estimation models and rebuild any models that otherwise may produce unreliable results in the foreseeable future.	SBA will assess the soundness of its models and rebuild any models that may be unsound.	September 30, 2003
2. Ensure that the documentation requirements of Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, are met.	SBA will prepare supporting documentation according to Technical Release No. 3.	September 30, 2003
3. Develop an objectively verifiable estimate for pre-1992 guarantee loan default liability utilizing risk factors in accordance with SFFAS No. 2; and maintain sufficient documentation to support the assumptions in the calculation model; and perform a thorough analysis to ensure that liquidating fund account balances and account activity are accounted for and presented in accordance with SFFAS No. 2.	SBA will prepare a documented analysis to address this matter.	August 15, 2003

4. Assess whether SBA has devoted sufficient resources to adequately address its current financial reporting shortcomings and determine if the current process will need re-engineering and additional resources to enable SBA to meet accelerated financial reporting deadlines in future years.	SBA intends to bring additional resources to assist with financial reporting, beginning with the second quarter's financial statements. These resources will be employed through the end of the annual reporting process.	September 30, 2003
5. Perform fluctuation analyses and determine reasons for all material changes in all financial statement account balances to permit inaccuracies that become obvious while performing such analyses to be corrected before submitting draft financial statements.	SBA will identify changes to financial statement line items outside established criteria, and will further analyze all amounts falling outside these criteria.	May 15, 2003
6. Re-engineer and enhance SBA's financial-reporting quality control process, to achieve minimum reliability expectations for draft financial statements.	SBA will enhance its quality control via additional reviews of quarterly financial statements and by taking other measures.	August 15, 2003
7. Develop and implement procedures to review obligated and unobligated balances remaining in liquidating funds at the end of the fiscal year, and de-obligating unneeded undelivered orders and returning them to the general fund at the end of each fiscal year.	SBA is evaluating its options to enhance compliance with this requirement. One possible option is to enhance the Financial Reporting Information System to include daily loads of loan data.	September 30, 2003

8. Develop and implement an integrated funds control system that allots the lesser of apportioned authority or realized resources at the fund and cohort level.	SBA will evaluate possible enhancements and implement those deemed appropriate.	June 30, 2003
9. Develop and implement a process to ensure that apportionment amounts are accurately recorded in SBA's GL, which includes documented supervisory reviews as necessary to reasonably assure reliability.	SBA will transfer responsibility for recording apportionments back to its budget office, where it can assure that stronger controls will be maintained.	June 30, 2003
10. Develop a process for estimating SBA's ownership in earnings from the MRF that provides accurate, complete, and timely data for the financial statements.	SBA will enhance its estimates of the MRF's residual value so that more reliable data can be provided for future periods.	October 15, 2003

Mr. PLATTS. Mr. Menth.

STATEMENT OF BILL MENTH, CONSULTANT TO COTTON & CO.'S SBA AUDIT TEAM FOR FISCAL YEAR 2002, POSTAUDIT CONSULTANT TO SBA

Mr. MENTH. Mr. Chairman, members of the committee, good afternoon. I join with others in thanking you for the opportunity to discuss SBA's loan assets sales and financial reporting.

Before presenting my testimony, I should state that I have worked in three capacities related to SBA's credit programs. From 1986 through 2001, I worked with the Office of Management and Budget, where I had a substantial role in implementing credit reform. My time at OMB included a significant amount of work specifically with SBA's credit programs. I retired from OMB in 2001.

From June 2002 through January 2003, I was an advisor to the audit team for Cotton & Co. In that capacity I contributed to the analysis of the disaster loan sales in the Master Reserve Fund, which in turn contributed to the disclaimed opinion. Then in March 2003, several weeks after the audit engagement was concluded, SBA contracted with me to advise them on the resolution of the disaster loan issue.

Today my testimony will focus on three themes drawn from my experience with the 2002 financial audit: first, on the role of credit estimates in financial statements; second, on the current state of standards and guidance for estimates used in accounting for the loan asset sales; and third, on the need to help other Federal agencies benefit from SBA's recent experience.

You've already heard that SBA's financial statements received a disclaimed opinion, largely, though not exclusively, because the gain or loss on $5 billion in loan sales could not be stated accurately. I will add a few details to what you've heard already to lay a basis for a point I wish to make.

Briefly, a loan sale results in a gain when the net proceeds from the sale exceed the book value and a loss when the opposite is true. In that equation the net proceeds are calculated using actual cash transactions. However, the book value, contrary to what the name might suggest, is a present value calculation of the estimated cash-flows that would have taken place if the loans had been kept rather than sold.

In drawing attention to the distinction between actual accounting for cash transactions and cash-flow estimates, I wish to emphasize where we must look for solutions. The disclaimed opinion was due to the errors—the disclaimed opinion was not due to errors in the accounting for the cash proceeds. The problems resulted from the faults in the statistical models used by SBA. The fundamental defect is the inability to estimate specifically the remaining cash-flows of the loans sold and, therefore, the book value of the sale. Therefore, the problems must be resolved by placing—by replacing the existing disaster loan model with a new model that meets all standards, both explicit and implied, and provides cash-flow estimates on a loan-by-loan basis. This is what SBA has engaged me to assist them in doing.

The distinction between estimates and actual accounting for cash transactions is important for another reason. While there are well-

developed standards for actual cash transactions, the standards for estimates, especially those related to loan sales, do not have the same degree of evolution and refinement. This leads to my second theme.

In recent years the disaster loan model has been subject to a wide review. In addition to SBA staff and SBA auditors, the model is reviewed by outside firms to validate its methods, and by OMB and by GAO. I am not aware of any instance where the fundamental defect was identified.

The failure to identify that defect despite the time and talent available is curious indeed. In my view, it cannot be attributed to a lack of seriousness of purpose or a shortfall in professional capabilities. In fact, I have a high professional regard for all those that were involved in the matter.

Instead I would like to suggest another explanation: that the standards and guidance for credit estimates did not evolve as quickly as was needed. In particular, while guidance was provided under one heading for cash-flow estimates and under another heading for loan sales, there's little guidance provided regarding the incremental requirements for cash-flow estimates when they are used for loan sales.

I believe it is fair to say that as a result of SBA's experience, that more explicit guidance can be given now regarding loan sales. Had the need for such guidance been apparent earlier, I believe it would have been made available. In any case, I trust the experience will have a beneficial effect on the evolution of standards and guidance.

My final theme is a suggestion for how other credit agencies can benefit from SBA's experience. Other agencies are currently selling loan assets; additional agencies may sell them in the future. I would encourage the development of a lessons learned document—I don't believe I'm unique in this—in which all of the parties, SBA, OMB, GAO, SBA's auditors, contribute freely.

Thank you. I'll look forward to your questions.

[The prepared statement of Mr. Menth follows:]

Testimony of
William C. Menth
before the
Subcommittee on Government Efficiency and
Financial Management
Committee on Government Reform
U.S. House of Representatives
April 29, 2003

Good morning. I join with others in thanking you for the opportunity to discuss SBA's loan sales and financial reporting.

Before presenting my testimony, I should state that I have worked in three capacities related to SBA's credit programs. From 1986 to 2001, I worked for the Office of Management and Budget and had a substantial role in the implementation of credit reform, including the development of the concepts and methods used for estimating credit subsidies. My OMB work included a significant amount of work specifically with SBA's credit programs. I retired from OMB in 2001. From June 2002 through January 2003, I was an advisor to the audit team for Cotton & Company. In that capacity, I contributed the analysis of the disaster loan sales and the Master Reserve Fund, which, in turn, contributed to the disclaimed opinion. Then, in March 2003, several weeks after the audit engagement was concluded, SBA contracted with me to advise them on the resolution of the disaster loan issue.

This morning, my testimony will focus on three themes drawn from my experience with the 2002 financial audit:

First, on the role of credit estimates in financial statements;

Second, on the current state of standards and guidance for estimates used in accounting for loan asset sales; and,

Third, on the need to help other Federal credit agencies benefit from SBA's recent experience.

You have already heard that SBA's financial statements received a disclaimed opinion largely, though not exclusively, because the gain or loss on over $5 billion in loan sales could not be stated accurately. I will add a few details to what you have heard already to lay the basis for a point I wish to make.

The gain or loss on loan sales is substantially determined by *estimates* of loan cash flows

Briefly, a loan sale results in a gain when the net proceeds from the sale exceed the book value of the loans sold and a loss when the opposite is the case. In this equation, the net

proceeds are calculated using actual cash transactions. However, the book value, contrary to what the name might suggest, is a present value calculation of the estimated cash flows that would have taken place had the loans been kept rather than sold.

In drawing attention to the distinction between actual accounting for cash transactions and cash flow estimates, I wish to emphasize where we must go to find solutions. The problems that led to a disclaimed opinion on SBA's financial statement did not result from errors in accounting for the cash proceeds. The problems resulted from faults in the statistical model used by SBA estimate the remaining cash flows. Therefore, the problems will be resolved by replacing the existing disaster loan with a new model that meets all standards – both explicit and implied – and provides cash flow estimates on a loan-by-loan basis. This is exactly what SBA has engaged me to assist them in doing.

The distinction between estimates and actual accounting transactions is important for another reason. While there is a substantial body of standards for the accounting of actual cash transactions, the body of standards for estimates, particularly as regards future cash flows for Federal credit programs, does not have the same degree of evolution and refinement.

And, this leads to my second theme.

Standards and guidance for estimates need to evolve further

In recent years, the disaster loan model has been the subject of a broad review. In addition to SBA staff and SBA's auditors, the model was reviewed by outside firms to validate its methods and by OMB and GAO. I am not aware of any instance where the fundamental issue – that the model could not adequately identify the cash flows of loans sold and, therefore, the book value of loans sold – was identified.

The failure to identify a serious defect, despite the time and talent available, is curious indeed. In my view, it cannot be attributed to a lack of seriousness of purpose or shortfall in professional capabilities among those involved. Based on my professional contact and experience, I have a high regard for the capabilities and dedication of all who were involved.

Instead, I would like to suggest another explanation: that the standards and guidance for such estimates did not evolve as quickly as was needed. In particular, while guidance is provided for cash flow estimates and, elsewhere, guidance is provided for loan sales, there is little guidance provided regarding the *incremental* requirements for cash flow estimates when they are used for loan sales.

I believe it is fair to say that, as a result of SBA's experience with disaster loans, more explicit guidance can be given now for the preparation of estimates used for loan sales. Had the need for such guidance been apparent earlier, I believe it would have been made available. If so, it would have accelerated the diagnosis of this problem and repairing the defects.

In any case, I trust that this experience will have a beneficial effect on the evolution of standards and guidance in this area.

Other credit agencies can benefit from SBA's experience

My final theme is a suggestion for how other credit agencies can benefit from SBA's experience. Other agencies are currently selling loan assets and additional agencies may sell them in the future. As we move toward a solution for the disaster loan program, I would encourage the development of a "lessons learned" document in which all of the parties – SBA, OMB, GAO, and SBA's auditors – contribute freely to a broad discussion that covers:

> The origins of the disaster loan defects and other areas where credit agencies might look for similar defects;
>
> The kinds of changes in cash flow models and related methods that are required when loans sales are contemplated; and,
>
> The specific ways in which standards, guidance, and case studies can be improved.

Thank you and I look forward to your questions.

Mr. PLATTS. Thank you, Mr. Menth, and all of our witnesses for your testimonies.

I think one of the things that came through in your oral testimony here today and your written testimonies is the partnership that's come out of what's been discovered about the modeling problems and how that's translated; and clearly, with GAO, with the CFO at SBA, the inspector general, the auditors that you're working hand in hand with each other to try to learn from what went wrong and then have a positive result not just for SBA, but as was just referenced for other agencies involved in loan sales as well. That's certainly what we're hoping, that this hearing will kind of further bring light to that effort and allow all in the Federal Government to benefit from this process.

For the most part, as we turn to questions, we'll follow the 5-minute rule for each committee member. And after we've done the first round, we'll certainly be glad to come back around then. With there being a small number of us here, if you need a little extra time as we go through that first round, that's fine.

I'm going to begin with a question really for the whole panel. Given the issues that have been identified now and that you're seeking to resolve, and to prevent the modeling problems in the past and have a more accurate model, would you recommend that there should be no loan sales done at all, not just by SBA, but by other Federal agencies, until this additional guidance is solidified and then put out there and a better model is in hand; or in the alternative, that we at least have—my understanding in trying to get a handle on this is that the sale of partial cohorts as opposed to a complete package of cohorts maybe compounded the problems that occurred. So would you support either of those alternatives, or do you think that we can go forward without one of those being adopted?

Ms. CALBOM. We'll go in order then, I guess.

Mr. PLATTS. That's the easiest probably.

Ms. CALBOM. Bill will get to think a long time about his answer. I guess, you know, this is a very complicated issue as we've all been talking about, and we haven't even begun to even scratch the surface of the complexities. But as far as additional sales going on, we recommended in our report that SBA needed to get their accounting squared away before they would carry on additional sales.

I think when you're talking about other agencies, they need to have the demonstrated ability to do the type of calculations that are necessary to properly account for these loan sales. I mean, it might be a suggestion that some kind of a dry run be done with an agency, again, to be sure that they can actually do this.

But the complexity of the partial cohort certainly, at SBA, made it more difficult. The way that they do their modeling, they really aren't able to directly allocate the allowance on a partial cohort basis, so it does make it even more complicated.

Mr. DUMARESQ. I guess the only thing I'd say is that the problems that we're experiencing with asset sales are related very specifically to the sale of disaster home loans, which are low-interest, direct government loans. We also sold some 7(a) business loans that had defaulted, and we didn't see the same problem. GAO rec-

ognized some problems with our accounting that we corrected, but we don't see the same anomalies coming up on that side.

My point would be that I don't think that our experience necessarily should lead to other agencies stopping loan sales. I do think that they should certainly do their homework as they're doing this and thoroughly evaluate the results of the sale after it takes place to make sure that they have a good handle on what the actual costs are and whether it's consistent with their estimates. The cohorts certainly would have made it easier, but it seems to me that we have enough data available to us to analyze the results of the sales and the remaining portfolio, and I would presume that other agencies would, too.

So it's possible to do, but I think that it really has to be done with a thorough evaluation of the results and the costs.

Mr. MCCLINTOCK. I would tend to agree with Tom. I can't speak for other agencies, but I would strongly recommend that SBA not do anything until we fully understand what all the consequences are of the sales that we've already had. And there are some issues that will come out of this in terms of both funding the losses and also issues in terms of funding the contractors that SBA hires to facilitate these sales. The assumption is that we have to enter into contracts in order to do the due diligence aspects of a loan sale, and the money that we use to pay those contractors actually comes out of the proceeds. Part of the process is that we make a determination—whether it's been right or wrong, we make a determination of whether we will receive enough value for the loans that we're selling in order to proceed. If we end up in a position where we have to make the determination that we do not receive enough value, then we don't proceed with the loan sales.

But we've funded millions of dollars up front with contractors in order to determine—in order to prepare for the sale. Those types of questions are kind of peripheral to the accounting issues. It gets more into the management issues in terms of how an agency runs its programs and so forth.

As for partial cohorts versus full cohorts, certainly the accounting would be simpler under full cohorts. I'm sure you would have others that would argue that if they were restricted in selling just cohort loans, that they wouldn't maximize the value that they received for loans. So there's a tradeoff in terms of the simplified accounting versus maximizing results.

Mr. PLATTS. Mr. Hayward, did you want to say something?

Mr. HAYWARD. I do. I see that we're a little bit over on time, but I would like to say a couple of things briefly.

As to the first question, as Pete said, I think that we get into some programmatic issues that we as auditors don't directly involve ourselves in in the financial statement scope. I would add, however, that I've heard nothing that I disagree with along down the lines. I think as a taxpayer it may very well be prudent to relook at whether we should—SBA should continue to sell these loans here without knowing further information.

As to the second point, Pete hit what I was going to say, and that is there needs to be balance. I think this answer is a little bit too rigid to say that, yes, we should sell it by cohort.

Mr. PLATTS. Quick followup before I yield to Mr. Towns. Mr. Dumaresq, when you emphasize with SBA or other agencies that continual evaluation that is now clear as far as the models, is it giving you an accurate reflection? What would be your best estimate as far as why that did happen with SBA, that we had 50 percent or so of the loan sales occur before having some review; you know, after 20 percent or 30 percent that we went so far forward before saying, hey, we need to do a review, or something came to light that told us that we had to do a review? It seems like that's when it prompts you. We were pretty far along before we did that type of evaluation that you're talking about.

Mr. DUMARESQ. I guess—that's a difficult question for me to answer.

Mr. PLATTS. I realize your timing and when you came in, and trying to look back, you know, it's——

Mr. DUMARESQ. I'd say two things. First, the results—and I don't think we've raised this before, but the fact that the asset sales proceeds were less than the net present value shown on the financial statements was a theoretically possible outcome, and so it was not a situation where the fact that we showed a loss on the financial statement after sale too immediately would have raised the red flag necessarily. On the other hand——

Mr. PLATTS. A theoretical possibility, wouldn't that probably tell you that your model for assessing the book value then is skewed? I mean, that would tell you something's off there if you can—it is possible, but there is still going to be a problem somewhere, in the value assessment.

Mr. DUMARESQ. Let me say this: When I came on board, shortly after coming on board, I was made aware of the fact that this situation existed, that we were showing very large losses, and as rapidly as we could employ the resources to do it, I asked for an evaluation of the loans sold versus the loans held and whether the results we were seeing actually supported the presumption that there was no impact on the subsidy rate. I don't know why that wasn't done earlier, nor whether it was appropriate earlier, but that was what I felt was appropriate as soon as I found out what the situation was.

Mr. PLATTS. OK. Thank you.

I now yield to Mr. Towns for the purpose of questions.

Mr. TOWNS. Thank you very much, Mr. Chairman. And I don't want you to think I'm involved in terms of wanting to blame somebody, but I really want to make certain that I understand the reason for the mistakes. Was it the complexity of the sales, or was it just a lack of expertise within the agency? Or is there something that we need to do on this side to be able to assist you in correcting? To Mr. Dumaresq.

Mr. DUMARESQ. I guess I'd say that it's difficult—I wouldn't necessarily characterize what happened as being the result of errors or mistakes in the sense that it was a situation where the wrong data was input or something like that. What you have here under credit reform is a situation where models are developed to estimate costs. They are only estimates. And these, the estimates that we were using, turned out to be not accurate enough to deal with the

sale of these assets and weren't accurate enough to accurately assess the cost of the program.

Now, over a period of time, the way credit reform is supposed to work, on an annual basis there is a reestimate that's done with actual data. So it is a kind of a self-correcting process. You know, it—it is a very complex set of circumstances. I think some of the best people in the field were available to SBA and were drawn in as consultants and reviewed the different components. To really get a handle on this problem, you had to look at the results across the three areas, across the whole model that was predicting what the asset sale would bring, subsidy model that was estimating the cost of the loan program and the accounting. It seems like each one of those different elements had been reviewed in detail individually, but as a group the overall answer, all together, the answer was clearly needed further evaluation, and that additional step wasn't taken.

So, like I say, it is a very complex set of circumstances, and as soon as I came in and became aware of the situation, we started to address it.

Mr. TOWNS. Right. I think the point I'm saying, do you feel comfortable that you have the expertise within the agency to deal with this problem? And can you really correct it? And I think you said something about reaching out and getting consultants. But even in order to do that, you still have to have a certain amount of expertise within the agency. Do you feel that you have that?

Let me just tell you where I'm going with this. You know, I don't want to—you know, a lot of times we sit over here on this side and blame—you know, is there anything that we need to do here as Members of the U.S. Congress to help you, to assist you in making the corrections that need to be made? Because I'm troubled by the fact that evidently you have to stop for a while and make all these corrections, make all these changes. In the meantime, you know, people that need the service will not be getting it.

Mr. DUMARESQ. Well, I don't think there will be any impact on the program delivery at SBA because of that.

Mr. TOWNS. Well, I thought Mr. McClintock mentioned the fact that maybe there should be a delay. Am I quoting you right?

Mr. MCCLINTOCK. Correct. But it really relates more to funding issues and——

Mr. TOWNS. That's service.

Mr. MCCLINTOCK. Right.

Mr. TOWNS. In my neighborhood.

Mr. DUMARESQ. Well, none of the loan programs would be impacted in any way.

Mr. TOWNS. OK.

Mr. DUMARESQ. In other words, we're engaged here in the sale of loans after they've been made.

Mr. TOWNS. Right.

Mr. DUMARESQ. So, before we sold loans, we serviced them inhouse, and we're continuing to do that.

Mr. TOWNS. So this will not stop or will not delay in any way.

Mr. DUMARESQ. No. No. There's no impact on SBA's programs.

Mr. TOWNS. Ms. Calbom, do you want to add something on that?

Ms. CALBOM. I think what Mr. Dumaresq is saying is that basically it's not slowing down their activity as far as making new loans, but what it is slowing down is packaging of those loans and then selling them to other buyers who would then service them.

So as far as providing the funds out there in the small business community, it wouldn't impact that. What it does impact, then, ultimately is who is servicing the loans, and it impacts how much of SBA's resources that they devote to carrying out the loan servicing function. The more loans they sell, then theoretically the less of their resources that they have to devote to servicing those loans.

Mr. TOWNS. Right. I guess, Mr. Hayward, how did your firm miss what seemed to be such a major accounting problem? How did you miss it?

Mr. HAYWARD. Well, I think we missed it in the context of some of the complexities involved, some of the inherent risk that we've got here to deal with short milestones. And I think notwithstanding those two factors that we did do extensive tests of these balances. We had statistical people at our side back in 2002 and 2001 to thoroughly go through these models. We looked at the outside consultants' reports that unanimously, I think it's fair to say, painted a picture that there were no problems conceptually with these models.

So I think Congressman Towns, that we see here a situation where we perhaps could have been more skeptical in the circumstances, but by the same token, I think we have a substantial body of audit evidence to support our conclusions, which at the time we felt were reasonable.

Mr. TOWNS. I guess the question I wanted to ask, can we safely say that this will not happen again? I mean, that's where I'm trying to go.

Mr. HAYWARD. Well, we're taking steps to assure that this won't happen. Pete, I think, referred to a number of those steps, and they are always referred to in our words, in our testimony. In brief, those steps are to increase substantially the amount of inputs from a recognized credit reform expert that we have on staff and also the independent partner on the engagement. Her name is Cathy Nocera. Second, we will be bringing onto the engagement a recognized "name" credit reform expert to manage that side of the audit.

Now, there's two parts to managing that side of the audit, Congressman Towns. The first side is evaluating the models and whether they are sound, and the second side is to evaluate the corresponding accounting. These are two different disciplines that we need to bring and that we will bring.

Last, we want to have our work peer-reviewed by a credit reform expert that has been uninvolved in the audit to date. We intend to bring this person on late—well, midpoint in the audit to make sure that we have mutual understandings of the expectations here for that person. Again, this person is independent. And then later in the audit we will feed that person our conclusions that—as we see them so that person can criticize and maybe draw some constructive changes if they're appropriate to our conclusions.

So we are taking specific steps to minimize, if not eliminate, this possibility.

Mr. TOWNS. Thank you very much, Mr. Chairman. I see my time has expired.

Mr. PLATTS. I now yield to Mrs. Blackburn for the purpose of questioning the witnesses.

Mrs. BLACKBURN. Thank you, Mr. Chairman, and thank you to the panel for being with us today. We appreciate this very much.

Ms. Calbom, thank you for the report, your book. I wish I'd had this a little bit sooner. It does have some great information in it.

I'm going to go to page 12 of this report, and, Mr. Dumaresq, I'm going to address you the first question. Let's talk for a moment, if you will, please, sir, about who is buying these loans.

Mr. DUMARESQ. The loans are actually purchased by large financial institutions for the most part. There are some small financial institutions who've bid on some of the pools that we've seen.

Mrs. BLACKBURN. OK. Great. Thank you.

Now, let's talk. I'll continue with you, if you will, please, sir.

What is the liability or the responsibility that the SBA bears for the inaccuracies and maybe flawed due diligence in that sale?

Mr. DUMARESQ. You mean with the purchaser, the ultimate purchaser?

Mrs. BLACKBURN. Yes.

Mr. DUMARESQ. That's not something that I deal with regularly, we can get an answer for you and submit it later on.

Mrs. BLACKBURN. OK. Did the SBA or its auditors consult with the risk assessment experts during this sale, the loan sales evolution?

Mr. DUMARESQ. Yes, there are financial experts that are on contract with the program, people as they're formulating the sales, putting what belongs together and throughout the entire process. And we also use consultants in the Office of the Chief Financial Officer to develop our models and the full rates and other things.

Mrs. BLACKBURN. OK. Are you aware of the type of due diligence that the purchasers of the loans are engaged in?

Mr. DUMARESQ. I know that they do their own due diligence, and SBA does due diligence prior to the sale as well. I'm not completely familiar with what they do.

Mrs. BLACKBURN. OK. Then looking at page 14 of the report, the middle paragraph there says, "SBA's due diligence is the most costly and probably the most important element of the loan sale process."

Mr. DUMARESQ. Yes, that's correct. There is a significant effort that goes into making the loan data, information from the loan files, available electronically to the potential bidders, so that they can get a good idea of what they're bidding on. And that's proved to be the most costly part of the asset sales.

Mrs. BLACKBURN. OK. And is the percentage correct, that it can be even as much as 87 percent of the total sales cost?

Mr. DUMARESQ. That, I believe, is correct.

Mrs. BLACKBURN. That is correct. OK. Anyone else have any comment on that? No? Absolutely not? OK. I did have, either Ms. Calbom or Mr. Dumaresq on this, how much is it going to end up costing us to address the situation with the SBA and the loan program? What do you anticipate the total cost to be? Because we've heard from Mr. Hayward, we have the outside consultants, some

more people are being brought on, what type of expenditure, and then also what type—timeframe are we looking at to get this straightened out?

Mr. DUMARESQ. We do not anticipate a situation where we would be asking for an additional appropriation the way—under Credit Reform we have an unlimited, perpetual appropriation that we draw against as we determine or find the cost estimate during the annual reestimates.

Mrs. BLACKBURN. Just a minute. Would you say that, again, did you say you have an unlimited?

Mr. DUMARESQ. Right.

Ms. CALBOM. Mrs. Blackburn, I think—were you asking about the cost of hiring consultants and others to analyze the problem?

Mrs. BLACKBURN. Absolutely.

Mr. DUMARESQ. I'm sorry; I misunderstood.

Right now, we're just in the process of awarding contracts for this, and I would say—I think the best thing to do would be maybe to provide you that information subsequent to the hearing. I'd rather give you an accurate assessment of what it will cost us.

Mrs. BLACKBURN. OK. Have you reduced any of your employee numbers at the SBA in order to allow for the additional cost of this? Are you making any personnel adjustments?

Mr. DUMARESQ. We are not making any personnel adjustments specifically to cover the cost of this, no.

Mrs. BLACKBURN. OK. All right. And what kind of responsibility exists, Mr. McClintock, coming to you, page 3 of your testimony where you're talking about the 1992 loan guarantees.

Mr. MCCLINTOCK. The question?

Mrs. BLACKBURN. Pre-1992, what kind of responsibility exists there? Or tell me what you think can be done about that. It sounds like you've gone back, you looked, there was a true problem that was there. Is there any way to go back and rectify part of that?

Mr. MCCLINTOCK. I think the problem for the pre-1992 loans concerns the basis for the accounting estimate that's entered into the records. Mr. Hayward probably can describe it better than me, but it's basically an allowance for loss account and the CFO's office estimates what that is. I believe during the audit that there was not sufficient documentation for the auditors to really assess the validity of the estimate.

Mrs. BLACKBURN. Mr. Hayward.

Mr. HAYWARD. Yes, Mrs. Blackburn, there were two problems, one of which was resolved during the audit.

The first problem with those pre-1992 loans was that the accounting had been historically done on budgetary bases and not also on proprietary bases. That problem was adjusted in the financial statements during the audit.

The second problem is, as Pete indicated, with the sufficiency and objective verifiability of the loss allowance corresponding with these loans that, once purchased, would default, and SBA, I believe, is working on that. And I, personally, I do not think that is a, is a problem whose solutions, which should and will drag on more than 1 year, I think that's imminently solvable, in other words, this year.

Mrs. BLACKBURN. As I wrap up, Mr. Hayward, I will go back to this first question I asked about any reliability or any responsibility that SBA may bear for due diligence that would be considered to be flawed. Due diligence by the customers who are buying these loans, is there any responsibility there?

Mr. HAYWARD. Well, I hope I understand your question correctly. It's my understanding that the SBA does perform substantial due diligence, and it's my further understanding that we, as part of our audits, do look at that. In recent years we've had Mr. John Murphy look at that. He is an ex vice-president in the banking industry, and he has substantial experience with due diligence assessments.

Mrs. BLACKBURN. Thank you, sir.

Mr. HAYWARD. You're welcome.

Mr. PLATTS. I'm going to followup on that and make sure, in trying to get to the due diligence of the purchasers of the loans, what goes into making the book value, you know, how accurate the model is in coming up to what is estimated.

I mean, the purchasers obviously are trying to make sure they're getting a good deal. So what are they doing differently or were they doing differently than SBA was doing in saying, "Hey, this is a good deal, and we're really going to be able to collect 50 percent more than we're going to pay here." They obviously had to have a, do have a model in place that they use. Is that something that the SBA has gone into, the private sector, people who were purchasing loans and say, "What are you using to value our loans?" So you're actually going to those who have been engaged in loan purchase transactions?

Mr. DUMARESQ. I know that our asset sales group has done quite a bit of research on what the buyers do as far as due diligence, and what they're looking for as far as the loans that we're selling.

I do not think I'm in a position to really give a definitive answer to you on what the results of that have been.

Mr. PLATTS. If you could followup in writing with us.

Mr. DUMARESQ. Sure.

Mr. PLATTS. That would be great. It's kind of learning from the reality of the marketplace, is what those borrowers are looking at and how they're making assessments, certainly as it relates to the book-value assessment that's going on. And that kind of translates as a followup on the questioning about the annual reestimates, that ideally there would be kind of a self-correcting process here. Given that the loans, the five sales in question were, I believe, in 1999 to 2002, what went wrong in those reestimates? Because GAO said that those reestimates were not really found to be very reliable. Why were they not? We're actually looking at true numbers, here's what we valued, here's actually what we got. So we're too high, too low?

What went wrong that those reestimates were not very credible and helpful? So that the second and third, actually, it would be second and third because if it's an annual reestimate, you're not going to have all that information for all of them, but what maybe did not happen that maybe should have? Let's start with you, and then have GAO.

Mr. DUMARESQ. Maybe Bill Menth is a better person to speak to that.

Mr. MENTH. Mr. Chairman, I'd like to make sure I understand your question correctly.

Reestimates, let us suppose you have a cohort from 1992 which expects to have a remaining life of, say, another 30 years because some of the loans in there were 40-year loans, approximately. The reestimate has two parts, a large part and a small part. The small part is the replacement of estimates with actual data for the 1 year just completed. The large part is the revaluation of the estimates for the remaining, now, 29 years. And the difficulties with disaster loan reestimates were largely due to the problem with the reestimates of the remaining years that were not yet actual, rather than 1 year that became an actual.

Mr. PLATTS. Maybe I'm misunderstanding that reestimate.

I was understanding or believing that it was really the value that the market's going to place on these type of loans that you learn from the actual price paid. So if you reestimate going forward, that you have a little better idea what the market's going to bear as you get to your next sale to have a more accurate book value, to line up better with the market. Maybe I'm misunderstanding how those reestimates can really be used or what they offer you.

Mr. MENTH. I think that's an important question to answer clearly. I'll take a minute to do it.

Reestimates are not a market-to-market transaction or calculation. When a loan is sold, that's an important piece of information about the value of those loans, and if the book value of the loans that were just sold was substantially different from the sales price, it's certainly an indication that there's some sort of a difference that needs to be analyzed and resolved.

There are some very good reasons why bid prices can be substantially below the book value of loans. One of the most prominent is that bidders will take into account their administrative costs in the price that they bid. The government does not take administrative costs into account in its book value.

For the disaster loans, these are all small face-value loans. The servicing cost of a loan, of course, is independent of the face amount of the loan. So when you have a large number of small face-value loans, the administrative costs can be substantial and can create a spread between the bid price and the book-value price. That does not indicate that the government has undervalued the loans, but rather there's an apples-to-oranges type comparison.

Even so, it's important if, for example, bids come in at 50 cents on the book-value dollar, that the differences between the book value and the bids be reconciled, to see if perhaps there's something being told you that suggests a revaluation of the original subsidy be made.

Mr. PLATTS. By the end of the day I will—you're already experts. You know the area. We'll be better experts, maybe, or trying to be. That maybe translates to another followup in why we started the sale, as opposed to servicing, in the first place. And it really goes to Mr. Towns' question about suspending the sales, not the fact that, Mr. Dumaresq, you say you really want the facts about the loans being issued. I'm assuming the reason we went to the sales in 1999 was because it was in the best interest of the taxpayer, be-

cause we're going to get a better return for the taxpayer by selling them and doing away with them, rather than keeping them in-house and servicing them in-house. So that the intent was sales will generate better return, less cost to operate the program because we get more money, better profit from the sale of it than servicing.

So if that's accurate, that's why we went to sales instead of servicing. If we suspend sales now for some period of time, indefinite at this point, it seems that we're getting a lesser return which means we're going to have a more costly program, which either means we need more money from the general fund, or you're going to be able to offer fewer program benefits to the public looking for the assistance.

Am I missing something here, I guess, is the question?

Mr. DUMARESQ. If I understand, then what we're finding is that the problem is that the asset sales may not actually give us the benefits that we thought that they would. In other words, our concern is that the asset sales are not keeping our costs constant, they may be increasing the cost, or may not be. We are not sure yet. We have to finish our evaluation, but unless we can show that there is a benefit to asset sales, we need to delay until we can show that.

Mr. PLATTS. That's the followup, and if you could submit, as you complete that review, submit that conclusion you've come to, to the committee as well, that would be helpful. With us being the Government Efficiency and Financial Management Subcommittee that we're—is it in the best interest to actually have these sales? The cynic in me would look back to 1999 and say that in the short-term, this helps our books because it gets a lump sum of money into the Treasury. So in the short-term, it makes the books look better for the Treasury. Although, long-term, if we do the analysis, it's really not in the best interest to sell for a flat fee. It's better to keep it, service it.

So I would certainly be very interested, and the committee would be interested, in what that analysis leads you to believe. Because it sounds like that's what you're doing as to whether you really want to return to sales at all or go back to pre-1999 and return to an in-house servicing and no sales.

Is that an accurate assessment of what you've stated?

Mr. DUMARESQ. Of course, there are other possibilities.

Yes, we want to find out whether the sales are beneficial or not, and the GAO touched on it in their report. Are there other operational benefits; are we reducing our servicing costs; are the sales beneficial; and are they reducing our servicing costs? Unless we can determine those clearly, then there's no point in going forward with them. And right now, we do not feel we can make that determination, and we want to get to the bottom of it before we go forward.

Mr. PLATTS. I guess I have more followup questions, but in fairness, I'm going to yield to Mr. Towns.

Mr. TOWNS. I'm sure happy you asked that question, because, you know, I was trying to figure that out, how this would not affect your mission. I got the impression or the feel that it would cut down on the amount that you could actually handle.

That's not true? Help me understand this.

Mr. DUMARESQ. Well, up until 1999 we serviced all of the disaster loans in-house.

Mr. TOWNS. Right.

Mr. DUMARESQ. At that point, we started selling well, the first sale was not disaster loan but business loans, but subsequently, we started selling disaster loans. We also started what was called a 30 percent home loan disaster servicing pilot where we took 30 percent of the disaster loan portfolio and contracted servicing out to a large business. The objective, I think, of the asset sales and the contracting pilot was to find out what was the most efficient way for us to handle the servicing and servicing of our loan portfolio.

To me, what we found, what's clear, in my own opinion, is that there are tremendous economies of sale in servicing loans and that unless—so it would be better to either contract out or sell the entire portfolio than it is to contract out or sell pieces of a portfolio.

What we found on the asset sale side is that the costs that we were incurring for servicing were not going down as quickly as the—as you might expect, given the percentage of the portfolio that we were selling.

Similarly, when we contracted out 30 percent of the portfolio, our costs remained relatively constant, and we didn't see as much of a decline because we had to maintain our in-house infrastructure that was used to service the loans.

So I think moving forward, we have to get to the, to come to a determination on what the best way to handle this loan portfolio is. The objective is to get to the lowest cost, most efficient way to service the loans and service the people that receive those loans, ultimately.

Mr. TOWNS. Yes. Mr. McClintock.

Mr. MCCLINTOCK. May I add one small thing to this?

As we said, most of these loans that we've sold are disaster loans. Disaster loan making is performed by our Office of Disaster Assistance. Servicing of those loans is performed by our Office of Financial Assistance. So it's two different groups within SBA.

Therefore, the folks that actually make the loans aren't impacted at all by loan sales. The services are there. Our Disaster people respond just as they always have and have the loans issued very promptly and timely.

So it's really the housekeeping at the back end of the process that is involved and it could be affected by the loan sales. It's the people in rooms with thousands and thousands of files of paper who, who either make changes to various terms of the loans, the collateral, accept the payments and so forth. It's the administrative costs that potentially could be reduced. The program aspects of making the loans wouldn't be impacted at all.

Mr. TOWNS. So if for any reason I did not sell any, that would not affect you. Wouldn't that stop them from making them?

Mr. MCCLINTOCK. Disaster loans are made in response to disasters, and there's clear criteria as to——

Mr. TOWNS. I understand that, but I want to have a real serious discussion on this issue.

I understand disaster and I understand the loan and I just think that if nothing is moving, it seems to me it might still hinder the

process in terms of who would be able to get, I just think that on the other end, it would be a little more difficult to process.

Mr. McCLINTOCK. On the front end?

Mr. TOWNS. Yes.

Mr. McCLINTOCK. They're separate functions, done by separate groups within SBA.

Mr. TOWNS. And they do not talk to each other? That's a real problem.

Mr. McCLINTOCK. The former Disaster Director said, "Every loan I make is a good loan and the other office has to service it, and if it goes bad, it's because of the bad servicing."

There are separate groups and the formulation of the loan, the loan approval is all done by—we have four different area offices and all they do is the front end of the loan. It's the servicing, the back end of the loan is done by either the contractor Tom mentioned or by servicing offices SBA has in other locations.

Mr. TOWNS. OK. Let me just sort of raise this quickly, Mr. Chairman.

Last year SBA actually deteriorated on a score for improving financial performance from the previous year. In addition to the loan asset sale problem, OMB raised questions about SBA's ability to meet accounting performance standards and measure risk in its loan portfolio more accurately. What steps are you taking to address these issues as well?

Mr. DUMARESQ. We've developed a plan to address all of the issues that were raised in the independent auditor's report and the GAO report moving forward, and we think that the plan will result in us clearing up those issues before the audit this year.

Mr. TOWNS. You feel very comfortable about that?

Mr. DUMARESQ. I do, I do. I really do.

We're totally committed to resolving the issues that have been raised. We have some challenges; there's no question about it. There's a lot on the plate, but we feel pretty confident that we can resolve the issues that have been raised this year.

Mr. TOWNS. Do you want to comment on that, Ms. Calbom?

Ms. CALBOM. Based on the discussions we've had with Mr. Dumaresq and others, we feel that they are on the right track, or looking at the right things. We have not had the opportunity to go in and really study the analysis that they have performed to date or the work that their consultants have done. I think the key is going to be that it is a thorough analysis, and that it has actually identified all the problems, because this is not a matter of just one problem. I think it's a matter of a number of problems that occurred, and so you just have to be sure that you found all the real issues that are impacting this, double-check it, do some reasonableness tests, check and double-check your assumptions. But as far as what they have told us they're doing, we feel like they're on the right track.

Mr. TOWNS. Thank you very much. Mr. Chairman, I yield.

Mr. PLATTS. Thank you. Mr. Towns, Chair yields to Mrs. Blackburn for the purpose of questioning.

Mrs. BLACKBURN. Thank you, Mr. Chairman.

Ms. Calbom, I know that there are other agencies, USDA and HUD, that are engaged in loan sales, and I'm sure we could say

there are plenty of lessons here that can be learned and applied there, but my question is this, is there a model in one of those agencies that could also be applied to the SBA to help them get on a firm footing?

Ms. CALBOM. Well, you know, we have not really studied in detail the loan sales that those other agencies have been carrying out, and I kind of go back to something I said before—I do not think loan sales caused the problems that SBA has. I think they brought them to light sooner than they would otherwise have been brought to light. I think the problems really had to do with, in general, how they were setting aside their allowances for their losses on their loans and then going in and checking to see if those allowances were adequate as they went along.

Now, whether they would have sold loans or not, the bottom line is, if you did not put enough aside to begin with for the costs of those loans, then you're going to fall short at some point and selling the loans actually forced them to recognize those losses sooner than they would have had to otherwise.

Mrs. BLACKBURN. OK.

Mr. Dumaresq, on page 2 of your testimony, your statement, where you said, "The changed IR opinion does not reflect a decline in the quality of our financial statements, but rather a more in-depth assessment by the auditor of what has been in our financial statements for a number of years," and I think this brings me back to a question that I asked and Congressman Towns has also touched on, you know, how far, how far back does the problem go and is there—are you washing your hands and saying that it was there and we did not deal with it?

Mr. DUMARESQ. No.

Mrs. BLACKBURN. So we're changing our behavior going forward or are you saying here is a way to go back and try to make this work as best we can.

Mr. DUMARESQ. The reason we make that statement is that we want to make it clear that it is a difficult situation. We also want to make clear that we have not changed the fundamental processes and that we have financial controls in place at the agency. We do not in any way disagree with the disclaimer, but we think that the disclaimer is primarily based on the asset sales issue which truly came to light this year or was viewed in this way this year.

And we feel it's important for everyone to be aware that we still have an ongoing, robust financial management system at SBA. We're continuing to use the same financial controls that we've had for the past several years. I think the clean audit opinions that the agency got for the 6-year period, were valid to a very large extent and that's the point we're trying to make here. We do not want anyone to think that we've just stopped employing our financial controls as we go forward.

On the other hand, we recognize the seriousness of the issues that have been raised and we're committed to dealing with them as we move forward.

Mrs. BLACKBURN. And at this point, how often are you all re-evaluating your loan portfolio?

Mr. DUMARESQ. You mean re-estimating the portfolio?

Mrs. BLACKBURN. Uh-huh.

Mr. DUMARESQ. Re-estimates are done annually, but right now, we are again engaged in a more detailed process particularly related to the disaster loan portfolio, where we're looking at the entire portfolio, including what was sold, and comparing with what was kept. So that's a much more detailed analysis than the normal re-estimating process.

Mrs. BLACKBURN. OK. Thank you.

Mr. PLATTS. Mr. Dumaresq, I'd like to followup on that question. When we talked about your analysis of the whole issue of loan sales versus in-house servicing of those loans. When you talked about contracting out 30 percent, that was contracting out the servicing?

Mr. DUMARESQ. Contracting out the servicing.

Mr. PLATTS. As part of the ongoing review now, are you factoring in your decision whether to not go forward with anymore sales and just do all servicing, the possibility of contracting out all of the servicing of all your loans? In the sense, have you talked about it's an economy of scales issue? That is, is getting rid of 30 percent going to save a lot because you have all the infrastructure?

Whereas, if you contracted 100 percent of the servicing of the loans, then you would not have the infrastructure, so that would make a different comparison on whether it would be good for tax payers or not? Is that part of your review?

Mr. DUMARESQ. I think, right now, we're focused on trying to figure out what the impact of the asset sales that we've had has been. What was the financial impact on the agency as a result of those sales, and that's a first step.

I think we still believe that asset sales can be a very beneficial thing for the government. It seem likes it could reduce our ongoing operational costs and free up resources for other purposes. We have to make sure that's, in fact, the case and once we do that, I think we will consider all the options and try and determine what the best, most efficient, way to handle the portfolio is.

Mr. PLATTS. In trying to prevent the problems with the sales in the past happening again in the future, the administrator has talked about the audit committee and, Mr. McClintock, you referenced it in your testimony. Can you give us an update, where is that proposal, what are the specifics, who would make up the committee? Is there any of that type of detail available yet that you could share with us?

Mr. MCCLINTOCK. No, actually, the decision to do this was made just within the last week or two but our plan is to coordinate with OMB. We have spoken with them. They have offered their assistance in terms of defining what a committee should do, identifying possible candidates to serve on that committee.

An audit-committee concept is only in place at a handful of agencies. I believe GAO has one and the FDIC has one. There are several agencies that are exploring establishing audit committees. OMB has been promoting the concept over the last 2 or 3 years. So in terms of assessing what happened and trying to come up with ways of overcoming this type of situation in the future, we thought an audit committee would be a good idea, and so we presented the proposal to the administrator. He said, "Good idea, let

us go with it." So it's something that's in the very early stages, but it will be up and going within the next few months.

Mr. PLATTS. What type, a few months is your estimate there?

Mr. MCCLINTOCK. We really have not even gotten that far in terms of doing it, but——

Mr. DUMARESQ. We're actively pursuing it right now. We are trying to figure out what the rules are, what we have to do. We want to get an audit committee up and running as quickly as possible, as we can——

Mr. PLATTS. As you flush out the specifics of the committee, the make-up, the parameter, if you could share that with the subcommittee, that would be helpful.

And the reference to GAO, if, Ms. Calbom, you could give us kind of an overview, if possible, of what your audit committee does, how it's made up and how it's been working, that would be helpful.

Ms. CALBOM. We've actually got several consultive committees that work with GAO. Our audit committee is involved in our financial statement audit, and I'm not particularly involved in that function. So I could not really give you the details on the make up and whatnot, but we'd be happy to provide that information for the record.

Mr. PLATTS. Maybe more directly to SBA, as you mentioned you're dealing with OMB is that, is it inferred that since you're aware of GAO's audit committee, that you're looking at what they have done as a model or possible model.

Mr. MCCLINTOCK. I'm sure we will look at GAO. I've heard Mr. Walker, the Comptroller General, talk about his audit committee, and I know he's very happy with it, and maybe he'll identify a person or two that could help us out. But we will certainly look at the structure they use, as well as any other committee within the government.

I think we would probably have to follow the Advisory Committee Rules. There are actually laws on how far an advisory committee goes and what their participation would be.

Mr. PLATTS. Maybe that kind of leads to the next question, the interaction between GAO and SBA on the audit committee is on the issue of the IBM review? That's my understanding, is a draft or preliminary review has been conducted as far as recommendations and given GAO is playing kind of a pretty helpful role here in identifying some of the challenges with the loan sales issue, is there a pretty open dialog between the two agencies right now, with regarding IBM's findings and recommendations that, as you're looking at those findings you're asking GAO for their commentary based on their involvement in this process?

Mr. DUMARESQ. We had a meeting, I think just last week, and we shared the findings of IBM. We have not shared the report itself because the IBM report is just a standard report that we ask for at the end of a contract.

We believe it's predecisional, and it's actually only a piece of what's been going on. IBM has been working in support of internal SBA staff to come up with a series of recommendations and testing different hypotheses.

Mr. PLATTS. What would be the harm in just sharing the report? I mean, what risk is there to just share the entire report rather than just summarizing it?

Mr. DUMARESQ. Well, as I say, we're happy to make all of the information in the report available to GAO and we have.

Mr. PLATTS. So you will share the report?

Mr. DUMARESQ. Right now, the agency's position is that the report is predecisional, and we have not released it. We can reconsider that or look at that decision again.

Mr. PLATTS. It just seems, given the role and as we started this hearing today about this partnership between GAO, SBA and your auditors, congressional oversight such as this hearing, of all working together for that end result being a good program, well, serving the people of our Nation, and GAO's quite significant role, even identifying some of the problems, it seems it would be the earlier you have them involved in the analysis of those findings, the better. I certainly would encourage and hope that you give my request, that you just openly share that information with GAO, serious consideration to do that sooner rather than later, to allow that dialog to continue in a positive way and just avoid the perception that there's something that you do not want to just lay out on the table.

Mr. DUMARESQ. I understand that, totally understand.

Mr. PLATTS. I assume that would be helpful as you continue, GAO continues, to look at the changes that are being contemplated in your analysis of what SBA's doing.

Ms. CALBOM. Yes, Mr. Chairman, we would want to look at that report. We would want to look at all the analysis that SBA is doing, you know SBA really has indicated to us that they are really leading the charge on this, and they're using the consultants to work with them. And so all the analysis they have done, we will want to look at when we eventually do this followup work.

We do believe we have access to that information, and we did talk about that with the agency at our meeting and requested that we be able to proceed in having that access.

Mr. PLATTS. My hope is that access will be, as we're all seeking that same common goal at the end of the day, that we just allow that to move forward in a positive way.

I have more questions but, Mr. Towns, did you have other questions?

Mr. TOWNS. I have questions I'd like to ask.

Let me ask you, I guess, Mr. Hayward. I guess I'm trying to figure out your role now. Are you still working to be able to put safeguards in place? Are you still involved or you just said, there's a problem and you're out? Are you still, I'm trying to make certain you are still involved in terms of safeguards? The point is that I want to know what is your role, now that—recognizing there's a serious problem, are you involved in consulting and working with them in trying to work out and solve the problem, or are you out?

Mr. HAYWARD. Well, in the first place, I'm actively involved in working toward some solutions here, to the absolute extent I'm able to do so and still retain my independence from SBA from management. Let me be clear.

Mr. TOWNS. I understand that, but I'm saying that recognizing there's a problem, are they consulting with you in terms of correcting the problem, are you being talked to? I understand your role, but the point is that, you know, are they talking to you in terms of how this might be fixed?

Mr. HAYWARD. Well, yes, sir. It's a two-way street. I have every right to ask as many penetrating questions as I think are appropriate, and conversely, management has shown, in the past, at least some decent cooperation with me to—in sharing its—candidly sharing some of its concerns.

So I believe the answer to your question is, yes and it's, it's multidimension—it's a two-way street, going back to the original statement.

Mr. TOWNS. Right, you answered my question.

The last question would be to you, Ms. Calbom. How can we apply what happened at SBA to other CFO's at agencies?

Ms. CALBOM. Well, I guess as far as other credit agencies, one of the key things, and something that GAO has looked at and recommended in some past reports we did some years ago, is, you know, you really have to make sure that you look at your models and that you're continuously updating the assumptions, challenging those assumptions, like, is my average loan life I've used in coming up with my cost, is that a reasonable loan life? Am I properly considering the amount of defaults that could occur? All those kinds of things that go into the costs of the loan programs, that you have to continuously update those and be challenging the original assumptions that you had, that was one of the big problems that appears that SBA had in some of our models, that some of those original assumptions were not right. And as I was mentioning before, the loan sales really brought that to light quite quickly.

So if there's one lesson that certainly would come to the top in my head. That's just in general.

Now, on the loan sales. I know that other folks on the panel have some thoughts on that, too. But I would say that before any agency starts to embark on loan sales, they really have to have their house in order as far as being able to properly account for, you know, the program to begin with, but then have the sophistication to be able to take on the added complexity of the loan sales.

Mr. TOWNS. All right. Thank you very much. I yield back, Mr. Chairman.

Mr. PLATTS. Thank you, Mr. Towns.

For Mr. Hayward and Mr. Menth, your audit report noted that SBA has weaknesses in compiling the financial statements and based on your long history with SBA, is it your position that to get to those clean audit opinions that have been issued, and prior to the 2000 year were pretty consistently issued as clean audits, was it the result of good processes in place all year, or more, that end of the year Herculean effort to make everything to fit together and to get to a position that allowed for a clean audit to be achieved? And I ask you that because when we've had the Comptroller General testify, his emphasis in the area of financial management and improving is that we have a structure in place that, at the end of the year he basically punched a button and it puts out what you need. As opposed to, go through the whole year, and then at the

end of the year, you're scrambling every year to get the data you need to show that you're in good shape.

Which would be your position of SBA's year in and year out practices, more good process or more end of the year scramble?

Mr. HAYWARD. Well, absent any change to our recommendations, I would have to say that we could expect some more heroism this year. We have made recommendations that are designed to lessen the heroism, so to speak, and more, more accurately to address the situation that you've addressed in your opening remarks, that is clean opinion is no indicator of sound financial systems.

I'd have to say that, in the context of the Federal Government, we have a number of agencies that are in the same boat as SBA. We have a situation where we've got a FRIES general ledger system that captures data that are needed to be crosswalked to the financial statements and the FRIE System. While functional, I think it's fair to say, requires a little bit too much labor to make it work. I think that our recommendations involving additional QC, particularly with respect to the first draft of the financial statements, will make it easier on both us and SBA in dealing with the short period of time that we've got after those first statements are issued to reach closure here.

Let me just repeat myself. I'm simply trying to convey that absent any change, with respect to our recommendations, I think that we can expect heroism, but in my experience with Tom, I believe he will be implementing some substantive responses to our recommendations.

Mr. PLATTS. And that's the hope of our efforts as a committee and the oversight role, is kind of dovetailing with the Comptroller General that focus be not just achieving that year end clean bill of health, but that we put in place the process that is more automatic, and it's not heroism at the end of the year and, you know, the focus here has been very much on the loan sale aspect, but as has been identified that's kind of brought to light maybe some broader challenges, and that structural change in some of the recommendations you make that will hopefully allow structure to be in place for a year in, year out clean audits being issued without problems.

Mr. Towns, did you have any other questions?

I'm going to move just to a closing and first, I want to thank all of our witnesses for your preparation and testimony here today and the followup information that you will be providing us, very helpful, very insightful, and a personal thank you to your efforts, whether it be as Federal employees or private-sector contractors working with Federal Government, for your efforts in trying to serve our constituents in good fashion. I appreciate your work.

I also want to thank both majority and minority staff members for their efforts in putting together the hearing, and we'll look forward to continuing to work as committee members and staff with each of you here today, as we continue to kind of watch the process as it goes forward, as you work as a team to have SBA's financial reports in good shape, and we can get from that red light in that, to the yellow, to green and get back to the clean, unqualified audits being issued.

Procedurally, we'll hold the record open for 2 weeks from this date for those who may want to forward additional submissions for possible inclusion, and this meeting stands adjourned.

[Whereupon, at 3:55 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

Linda Calbom, GAO
Responses

Enclosure

Responses to Follow-up Questions for April 29, 2003, Hearing

Vice-Chair Marsha Blackburn's Questions:

1. **Is there a best practices business model that could be taken from the banks and adapted to federal agencies for disbursement of loans?**

We are not aware of a specific private sector best practices business model that could be easily adapted to all federal credit agencies. However, there are likely lessons to be learned about loan accounting systems and loan valuation analysis from some private sector lending institutions that would be beneficial to federal credit agencies. Under the Federal Credit Reform Act of 1990 (FCRA), federal credit agencies must account and budget for the cost of credit programs based on the year funds are obligated. For example, an agency with 10 credit programs in effect since the establishment of FCRA could currently be required to annually reevaluate the cost of 120 portfolios. Larger, more sophisticated private sector lending institutions would likely have loan accounting systems and loan valuation procedures that could readily complete such analyses. However, since federal credit agencies do not have the same type of systems capabilities and automated procedures as large private sector lending institutions, the requirements of FCRA greatly increase workloads for federal agencies. Further, most federal credit agencies have only recently begun to develop and maintain historical data related to loan performance and loan characteristics that are as detailed as data maintained by private sector lending institutions. This often reduces agencies' ability to estimate the cost of their programs under various economic conditions.

In the past few years, federal agencies have made significant progress estimating the costs associated with their credit programs, and for fiscal year 2001, we were able to remove this area from the list of issues contributing to our disclaimer of opinion on the governmentwide financial statements. Nevertheless, some federal agencies, such as the Small Business Administration (SBA), continue to have significant deficiencies in the processes and procedures used to estimate the costs of their credit programs. The recently disclosed problems at SBA highlight the complexities associated with estimating the costs of credit programs and the need for continued oversight in this area.

2. What amount of savings would be produced if the loan functions of SBA were eliminated and replaced by guarantee loans to private financial lending institutions?

Determining the amount of savings, if any, that would result if direct loan functions at SBA were eliminated and replaced by loan guarantees to private financial lending institutions would require an extensive cost-benefit analysis that would compare these alternatives. This analysis would need to include an assessment of the numerous costs that are associated with providing direct loans versus loan guarantees and would require a formal effort to complete. We are available to meet with Subcommittee staff to further discuss the scope and magnitude of the type of analysis that would be necessary to answer this question.

Insert into the record:

Please provide details of the make up and function of GAO's audit committee.

As discussed in the fiscal year 2002 *GAO Performance and Accountability Report*, a three-member external Audit Advisory Committee assists the Comptroller General in overseeing the effectiveness of GAO's financial operations. During fiscal year 2002, the members were

- Sheldon S. Cohen (Chairman), a certified public accountant and practicing attorney in Washington, D.C., a former Commissioner and Chief Counsel of the Internal Revenue Service, and a Senior Fellow of the National Academy of Public Administration;
- Alan B. Levenson, a practicing attorney in Washington, D.C., and a former senior official at the Securities and Exchange Commission; and
- Katherine D. Ortega, a certified public accountant, former Treasurer of the United States, former Commissioner of the Copyright Royalty Tribunal, and a former member of the President's Advisory Committee on Small and Minority Business.

At the start of fiscal year 2003, two members informed us they were no longer able to serve on the board. Mr. Cohen is still the Chairman and the two new members are

- Charles O. Rossotti, a technology, management, financing and business development advisor, a former Commissioner of the Internal Revenue Service, a co-founder and former Chairman of American Management Systems, Inc., an international business and information technology consulting firm; and
- Edward J. Mazur, a certified public accountant and Vice President for Administration and Finance of Virginia State University, a former Federal government Controller, a former State Comptroller for the Commonwealth of Virginia, and a member of the Governmental Accounting Standards Board.

To fulfill its responsibilities, the committee meets with agency management and its internal and external auditors to review and discuss GAO's external financial audit coverage, the effectiveness of GAO's internal controls over its financial operations, and its compliance with certain laws and regulations that could materially impact GAO's financial statements. GAO's external auditors are responsible for expressing an opinion on the conformity of GAO's audited financial statements with U.S. generally accepted accounting principles. The committee reviews the findings of the internal and external auditors, and GAO's responses to those findings, to ensure that GAO's plan for corrective action includes appropriate and timely follow-up measures. In addition, the committee reviews GAO's draft performance and accountability report, including its financial statements, and provides comments to management, which has primary responsibility for the report.

Charles Hayward · Cotton + Co.

Attachment

Congress of the United States
House of Representatives
Committee on Governmental Reform
Subcommittee on Government Efficiency and Financial Management

Questions and Answers
Representative Marsha Blackburn
May 23, 2003

How long has Cotton & Company (C&C) been under contract for SBA?

The Inspector General (IG) awarded our first contract for auditing SBA's financial statements in the summer of 1991. We previously performed compliance audits for the IG of SBA 7(a) borrowers and participating banks during much of the 1980s. Records supporting details of the latter work have been discarded under the firm's records-retention policy.

What is the length of your contracts with SBA?

Our contracts have had one base year with four option years. The option years have all been exercised.

How many other contracts does C&C have with the federal government?

We presently have contracts with 19 federal agencies (or components thereof). Contracts with those agencies total approximately 30.

What is the average length of these contracts?

Our contracts' average duration is approximately four years. After that time, the work is recompeted.

How long has C&C been under contract with the federal government?

Since the firm was created in 1981.

What is C&C's total revenue from the federal government from contracts?

Last year, our total revenue from federal work was $9,842,208.22.

Thomas Dumaresq -SBA

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1. Please provide a synopsis of the research completed by SBA's asset sales group on what kind of due diligence the loan purchasers are performing; specifically how loan purchasers are determining the value of the loans before the sales.

A. SBA tries to provide the potential purchasers with sufficient information to generate the maximum bid amount from the investors. Through remote access, the potential investors may view electronic images of the loan files, current third party reports such as property valuations, credit reports, Phase I and/or II Environmental Reports, title reports, UCC searches and bankruptcy searches. SBA also provides the investors with a database that contains over 200 data elements, including three years of cash flows for each loan.

Investors use different techniques to determine their bid amount depending upon whether the investor is bidding on the entire portfolio or the smaller designated pools, and whether the loans are performing or non performing. If the loans are performing, the investors bid amount may be determined by analyzing the cash flow data. If the loan is non-performing, the type, quality and quantity of collateral become more important. If the loans have a high unpaid principal balance (UPB) or are concentrated in a specific region (Guam, Caribbean, California, Texas, etc), the potential investors may conduct site visits.

SBA does not specifically know how an investor's bid is calculated, since this is proprietary information and the investor's return on investment requirements may vary considerably.

2. An evaluation of where the SBA now stands in making a cost-benefit determination about continuing to sell loans.

A. We have completed a preliminary analysis to identify the underlying cause of the shortfall in the subsidy allowance account for the Disaster loan program and are making progress on addressing that issue. However, additional analysis is required to determine the cost-benefit of SBA's asset sales program. We are currently undertaking that additional analysis and hope to have our determination made by the end of the fiscal year.

3. Any specifics of the audit committee at SBA (the make up, the parameters, functions, and goals)

A. The OCFO is working with the Inspector General's Office to establish an audit committee. We have gathered information from Treasury and GAO regarding their experience in establishing audit committees. We are currently drafting a charter for the committee and considering possible candidates to approach about becoming committee members. We are also investigating existing laws and regulations regarding Federal committee structures to ensure we follow the applicable procedures.

4. What is the liability or responsibility of SBA to purchasers for any inaccuracies or incomplete information concerning the loans for sale, such as loan maturity, which may have undermined the purchasers ability to conduct accurate due diligence review?

A. The SBA, in the Loan Sale Agreement (LSA), makes only two representations and warranties. The first, that the Agency has the power and authority to sell the loans and execute, deliver and perform all of the transactions in the LSA. The second, that the loan is

a valid and binding obligation of the borrowers or obligors, that the Unpaid Principal Balance is correct, the loan is fully disbursed and that the interest rate is true and correct in all material respects. It should be noted however, that the SBA provides either images or photocopies of all secured loan files for the comprehensive review by all investors prior to bid date. This ensures them the opportunity to review the loan files and raise any questions regarding maturity, interest rates or collateral.

5. What is the total book value of all loans SBA has made in all years?

A. SBA's current total portfolio (as of April 30, 2003) includes 337,890 loans for a portfolio value of $47.2 billion. This amount includes 101,274 Disaster loans with a portfolio value of $3.5 billion.

6. Who makes the decision on what loans get sold and/or serviced?

A. The Asset Sales Team with the assistance of the Program Financial Advisor reviews the asset sale selection criteria and determines the portfolio of loans to be initially selected for a scheduled sale.

7. What is the process that determines if a loan is sold/or serviced?

A. Prior to each sale, the Asset Sales Team reviews the entire remaining portfolio to determine which loans are available. Loans selected must be fully disbursed, with 2 years of seasoning between the date of approval and the bid date, and at least six months from the date of final disbursement (this is commonly referred to as the "two-year rule"). Also, the SBA excludes all loans in deferral status in an open Presidential or SBA-declared disaster area.

8. What is the timetable for SBA to reverse the process of losses on loans sold?

A. The "losses" SBA has booked on loans sold have been included each year in SBA's financial statements. To the extent that any adjustments are made to those loss calculations due to the analysis we are currently conducting, SBA plans to include those adjustments in its FY03 financial statements.

9. What is the model for how SBA allocates for salaries and how much of these allocations are rolled into the cost of selling loans?

A. Under the Federal Credit Reform Act of 1990, administrative expenses are excluded from the cost analysis for the purposes of calculating the cost of loan sales. Therefore the "loss" or "gain" reported as resulting from the loan sale has not included SBA salaries as a component of the calculation.

10. How are costs allocated for SBA's due diligence on loans?

A. The due diligence costs associated with the loan sales are allocated to the loans included in the sale on a pro rata basis. Expenses, such as due diligence costs, are deducted from the proceeds of the sale before the net gain or loss is calculated.